The New York
Certified Public Accountant

Vol. VIII | *July • 1938* | No. 4

THE NATURAL BUSINESS YEAR

PUBLIC UTILITY ACCOUNTING

INVENTORY METHODS

RETAIL ACCOUNTING

STOCK BROKERAGE ACCOUNTING

SOME DANGERS *of* OVER-REGULATION

Published Quarterly by
THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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—From the Certificate of Incorporation.

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The New York Certified Public Accountant

THE NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

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The Natural Business Year

By Ralph S. Johns, C.P.A.

THE principle of the natural business year well may be regarded as one of the most valuable concepts available to business today in the interest of economy and efficiency in the administration of its affairs.

The natural business year for any particular enterprise has been defined as "that period of twelve consecutive months which coincides with the annual cycle of operations of that enterprise. Generally the Natural Business Year will end when the business activities of the enterprise are at the lowest point in their annual cycle and when inventories, receivables and liabilities are reduced to their annual minimum. The natural year-end occurs just before the beginning of heavy inventory replenishment in preparation for a new season."

Before discussing the application of the natural business year principle to present-day business affairs, it may be of interest to review briefly some of the events which have contributed to its history. The Corporation Excise Act of 1909, enacted August 5, 1909, and applicable to the calendar year 1909, has been charged with causing accountants and business men considerable grief, including that of filing tax returns on a calendar year basis. It appears that prior to the enactment of this law, corporations were free to close their books when they saw fit and many, recognizing the seasonal character of their operations, took advantage of the opportunity by closing their books at dates other than December 31. The Corporation Excise Act of 1909 remained in force until February, 1913, the Revenue Act of 1913, made possible by the adoption of the sixteenth amendment to the Constitution, becoming effective March 1, 1913. The new law permitted the filing of tax returns on the basis of a fiscal year other than the calendar year. (Throughout this discussion the expression "fiscal year" will be used as defined in the tax laws as an accounting period of twelve months ending on the last day of any month other than December). The damage appears to have been done, however, for after approximately four years under the Corporation Excise Act of 1909, corporations generally were reluctant to return to a fiscal year of their own selection. Nor were the tax laws any too inviting for those who were considering the adoption of fiscal year returns. The provisions of successive revenue acts relating to income taxes following the Revenue Act of 1913 through the Revenue Act of 1932 became effective in each instance as of January 1. Fiscal year corporations frequently had to file returns under two different tax laws, involving differences in tax rates, exemptions, etc. Other difficulties were encountered when taxpayers changed their tax year so that the tax had to be calculated for a period of less than one year. In the opinion of many the situation was none too encouraging for fiscal year corporations as evidenced by the fact that most newly formed corporations adopted a calendar year. Beginning with the Revenue Act of 1934 and continuing up through the present law, however, not only have fiscal year returns been permitted but earlier discrimination against fiscal year taxpayers has been removed by deferring the

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Presented at the Regional Chapter Conference of the New York State Society of Certified Public Accountants June 24, 1938.

effective date of changes in the revenue acts, in so far as fiscal year taxpayers are concerned, until the next succeeding fiscal year. Thus the tax in each instance is computed under one law and the last argument as to discrimination or complications of fiscal year returns is done away with. New corporations may elect a fiscal year of their own choosing. Established corporations must obtain permission from the Commissioner of Internal Revenue to change their accounting period. The routine followed in changing from a calendar year basis to a fiscal year basis will be considered hereinafter.

During this period spasmodic efforts were made to encourage the adoption of fiscal years. Occasionally accountants would advocate natural business years in public addresses. One such address which has been preserved is that of Elijah Watt Sells in 1921, published along with other addresses at the time of his death in 1924. In 1926 the Bureau of Business Research of the University of Illinois published a pamphlet on the natural business year which was based largely on replies received in response to questionnaires addressed to business men, bankers, accountants, and others. Probably the most concerted effort to bring about a return of general use of natural business years was begun in the fall of 1935 when there was formed the Natural Business Year Council representing bankers, credit men, certified public accountants, cost accountants, trade association executives, and business management. The Natural Business Year Council has the active support of the Robert Morris Associates, the National Association of Credit Men, the National Association of Cost Accountants, the American Management Association, and the American Institute of Accountants. The purpose of the Council is "by research to determine the natural business year of each of the various subdivisions of industry; and by education, to encourage general adoption of the natural business years thus determined." Local councils organized along similar lines have been formed in approximately thirty-five of the more prominent cities throughout the country. Under the sponsorship of the Council a number of leaflets and pamphlets have been issued, the total distribution up to a recent date aggregating 132,721 items. Included in the list of publications is a tentative list of suggested fiscal closing dates for over two hundred industries and a series of pamphlets entitled "The Natural Business Year —A Means to Efficiency", "The Natural Business Year—Its Advantages to Business Management", "The Natural Business Year—Suggested Natural Fiscal Closing Dates". Dun & Bradstreet, Inc. is cooperating as an impartial fact finding agency in the research phase of the program by making studies in various industries to determine their natural business years. The first reports from this organization have been released recently. The Natural Business Year Council welcomes inquiries on the subject; it will gladly lend assistance where desired and its literature is available and can be obtained by addressing the Council at its offices at 135 Cedar Street, New York, New York.

Reverting to our definition of the natural business year, reference is made therein to a period of twelve consecutive months. By general custom and convention a period of twelve months has been adopted almost universally as a basic period for the presentation of financial statements, a custom which was not always so widely in use as at the present time. As we all know, the results of operations of a business enterprise cannot be expressed with complete accuracy except by consideration of the entire history of that organization from its inception to its final dissolution or liquidation. It is

unfortunate that the breaking up of that history into annual periods in order that current information might be available should have followed so generally the calendar year, which, after all, was adopted primarily as a uniform measurement of time and not to coincide with any particular economic cycle. There has been a definite trend in recent years as a result of legislation, activities of security exchanges, and so forth, to attach greater importance to financial statements today than ever before. Every effort is being made to improve the quality of financial statements by improvements in accounting technique, consideration of the form of accountants' certificates, and the formulation of accounting principles. It is likewise essential in order that financial statements may be made as informative as possible that serious consideration be given to the fiscal year to be used as the basis for reporting.

Parenthetically, it may be said that experience has demonstrated that the thirteen month year is sometimes confused with the subject of the natural business year. A corporation may be giving consideration to both matters at the same time but we should make it clear in our discussions with third parties that they are two entirely different concepts, although, of course, a natural business year and a thirteen month year may be adopted concurrently. In this connection it may be well to point out that the regulations require that tax returns must cover a period ending on the last day of some month, and, of course, that books must be kept, or else the return must be made for the calendar year. A corporation adopting the thirteen month year, therefore, should consider carefully the tax aspect of closing its books on the 29th, or 2nd, or 3rd day of the month whether the year-end be in the vicinity of December 31 or some other month-end.

What, then, is the proper fiscal period? Our definition refers to a period "which coincides with the annual cycle of operations" of an enterprise. Some corporations may find it an easy matter to determine their annual cycle of operations and in the complexities of our modern business life others may not find it so easy. A comparatively simple illustration would be the case of a theatrical enterprise putting on a complete new play each year running for the full season from September to the following June. Financial statements prepared on a calendar year basis would include the results of operations of the last six months of one play and the first four months' showing of the succeeding play. It is obvious that with such a theatrical enterprise a fiscal year ending with one of the summer months would be more appropriate and result in more informative financial statements. Similarly, suppose a corporation constructed but one ship a year or in some other capacity entered into but one venture a year. In the locality where I live there is a corporation which does nothing but make Easter egg dyes. For about four months of the year it manufactures these dyes, then for another four months its efforts are directed to selling and during the remaining months the accounts are collected. I do not know what the fiscal year of this corporation is but I have a pretty good idea what it ought to be. Coal dealers are frequently cited as representative of an industry which should avoid December 31, April 30 being a more appropriate closing date in this industry, at which time also the clerical force could devote its efforts to closing the books with far greater advantage than at the height of the active season. Department stores likewise illustrate a business where the transactions are numerous but where they run sufficiently concurrent, and with periods of high and low activity recur-

ring so regularly that, according to the National Retail Dry Goods Association, 80% of all department stores close their books at January 31 rather than December 31. In many lines of activity the proper fiscal year is not so obvious and reference to other industries will be made from time to time as we proceed with the discussion.

Financial statements, as we all know, no matter how skillfully prepared contain certain elements which cannot be measured with absolute accuracy but instead must be determined by estimate or judgment. This is due to the fact that at any date prior to dissolution there will be transactions which have been only partially completed. Our insistence that each statement period shall stand on its own feet involves allocations which again must be determined by estimate based upon experience and judgment of conditions. The fewer the uncompleted transactions at any financial statement date and the greater the extent of the conversion of assets into cash, the less the reported financial results will depend upon estimate. It is evident, therefore, that a corporation whose fiscal year begins and ends at a date when there are the fewest number of open transactions and unrealized operations can reduce the margin of error in its financial statements and the volume of work in their preparation as compared with a corporation that has a fiscal year ending at some other date.

It is unfortunate that more corporations have not recognized the self-evident advantages of selecting the proper fiscal year. As Mr. Charles B. Couchman, member and former chairman of the Institute's special committee on natural business year (who suggested some of the thoughts expressed at this point), has stated: "The great majority of business corporations today however efficient they may be in other respects, whatever amount of care they may have exercised in developing other factors of their business upon the most favorable basis, however much they may have expended in research and in planning and in the study of their problems, have completely overlooked this one step which would enable them to prepare more accurate financial statements measuring the results of their year by year operations."

The study made in 1926 under the sponsorship of the Bureau of Business Research of the University of Illinois indicates that, of four hundred thirty-nine companies reporting, 72% were closing their books on a calendar year basis. The study further indicates that an allocation of these same four hundred thirty-nine companies according to their natural closing date would leave but 44% on a calendar year basis.

Whenever this subject of the natural business year is discussed, the matter of inventories immediately looms up as a major factor in the picture. In fact, reference to inventories frequently is made a part of the definition of the natural business year. Elijah Watt Sells, to whom we referred previously as a pioneer in the movement to bring about a return to general use of the natural business year, said:

> "At the close of the natural business year we reach a point like a turn in the road, when we wish to review what we have done, to see the last twelve months in perspective, to find out where we stand financially. It is a time for new planning for the future, adjusting ourselves anew to conditions, seeing the most advantageous steps to take in preparation for renewed effort. It is the inventory, taken at this time, that will reveal to us the results of past effort and bring new wisdom to help us in building a better and finer future.
>
> "In this period following our year's harvest and in the lull preceding new seeding and planting, in our special line of business, for the next harvest, we have time to take an inventory. Then we are freer from the pressure of insistent effort, and immune from many distractions."

Mr. Sells states at another point:

"A glance at the cost in any concern taking inventory at a time when stocks are large and the sacrifice of business, including enforced shutdowns and the time consumed by employees who could be utilized advantageously in the conduct of the going business, would make an appalling contrast with the cost of the inventory at a time when the stock is the lowest and frequently there are surplus employees who can be utilized for the work without encroaching upon the demands of the heavy going business."

The advantages of taking inventory at the close of the natural business year are stated in the Council's pamphlets as follows:

"(a) Normal activities have temporarily ceased or substantially decreased at the end of a natural business year, and inventory can be taken without interference with productive operations.

"(b) Stock is greatly reduced and is moving slowly, if at all. It can be counted with greater ease and in less time than at any other date.

"(c) Members of the staff are relieved to some extent of the pressure of their normal duties and are available to assist in taking inventory—eliminating the expense of employing additional assistants, which is often necessary when inventory is taken at a busier season.

"(d) The margin of error in the valuation of inventory is reduced when the quantity of stock is low. Accuracy of valuation is one of the principal advantages of taking inventory at the end of a natural business year."

There is one further observation on inventories which I would like to add to those already stated. Both accountants and economists have been concerned with the various methods of inventory valuation and their effect upon the annual reporting of corporate income and on Federal income taxes. According to an editorial appearing in the June, 1938, issue of The Journal of Accountancy it appears that there may be fundamental differences on this subject between accepted practice in this country and accepted practice in England and that at least some economists hold to opinions contrary to present-day accounting practice. It occurs to me that the differences in results on this score may be minimized, both as to the dollar amounts involved and as to the relative importance of the several valuation methods advocated, by the adoption of the natural business year thus focusing the valuation procedure on the low point in the annual inventory.

While the matter of inventories always has been allied closely with the subject of the natural business year we should be ever mindful of the fact that the natural business year principle applies with equal force to corporations with little or no inventories. For example, corporations owning and operating office buildings in most instances have standard leases running from May 1 to April 30 or from October 1 to September 30. In such event the fiscal year appropriate under the circumstances should be adopted accordingly. To illustrate further, the automobile finance business has its seasonal fluctuations both with respect to the volume of wholesale paper on hand and with respect to the volume of retail paper being purchased. Based upon the operating conditions in the automobile industry during the past few years, September 30 would appear to be a logical closing date for automobile finance companies.

Nor should we lose sight of the fact that the principle of the natural business year applies to non-profit organizations as well as to profit organizations. Colleges and universities, golf and country clubs, hospitals and other charitable institutions, municipal corporations, and the like, all should consider fiscal years in lieu of the calendar year as the basis of accounting and reporting. Most colleges and universities already have adopted a suitable natural fiscal year, two-thirds closing their books at June 30, according to

information supplied by the Financial Advisory Service of the American Council on Education. Golf and country clubs represent a good example of organizations having a fairly long inactive period. The question frequently arises as to whether the fiscal year should end immediately after the active season or immediately before the next succeeding active season. Where this choice is available, it appears that the period immediately following the close of the active season is to be preferred. One should give official recognition to the year's results at the earliest practical date, thus giving opportunity for the consideration of the coming season's operations in relation to the season just ended, formulation of policies, etc. It is only fair to state, however, that there also is substantial evidence to support the contrary view, that is, ending the fiscal year at the close of the inactive season.

Most hospitals and charitable institutions keep their books on a calendar year basis. The American Hospital Association has gone on record officially that the calender year is the natural business year for hospitals. While it is true that the patient census is at a low ebb following the holiday season, there are a number of reasons why a fiscal year should receive serious consideration. For example, many institutions operate nursing schools which invariably are not on a calendar year basis. Appointments to the staff frequently are made for periods other than the calendar year. The position of accountants is a unique one in this instance. Much of the service is rendered at reduced rates. The work of necessity must be deferred until after the busy season which means delayed reports. In some instances it may mean engaging less competent accountants. The institute's correspondence during the past year indicates that accountants have a keen interest in this phase of the subject. April 30 and October 31 appear to be the dates most frequently recommended. Inasmuch as it is common practice for hospitals and other charitable institutions to receive contributions from community chests and kindred organizations based on their financial statements, fiscal year statements would permit the distribution of funds more promptly at the beginning of the year. The fiscal year of hospitals and other charitable institutions well might be made a matter of special study. It is not primarily a question of convenience to accountants, but the rendering of prompt, efficient service to institutional managements in such a manner as to serve best the interests of society. In this connection it is interesting to note that one charitable institution located in the City of New York changed in 1937 from the calendar year to a fiscal year ending September 30 and obtained permission from the Bureau of Research and Statistics, Department of Social Welfare, State of New York, and from the Division of Charitable Institutions, Department of Finance, City of New York, to file its reports on the basis of a fiscal year ending September 30 accordingly.

With respect to municipal corporations, a fiscal year ending June 30 appears to be as appropriate as any, particularly because such a substantial proportion of municipal expenditures is devoted to school purposes. We do not have complete information on the present practice of municipalities, but we do know that 75% of the states and the Federal government operate on a fiscal year ending June 30.

Returning now to industrial corporations, another advantage to management of the adoption of the natural business year lies in the fact that a balance sheet prepared at this date for credit purposes shows the concern in its most liquid, and, therefore, most favorable position. A statement of financial condition pre-

pared at this date will indicate clearly the ability of the concern to liquidate its bank loans at least annually. The pressure for "window-dressing" will be diminished considerably as compared with a closing date at an unnatural time of the year.

Looking at it from the other side of the picture, wide adoption of fiscal years would be of definite advantage to bankers, particularly credit bankers, by having statements coming for the attention of credit departments with more uniform distribution throughout the year, thus permitting more prompt, careful analysis of such statements than otherwise might be the case. The indications are that a vast majority of bankers approve of the natural business year idea. By way of illustration, I quote from an address delivered by Mr. Charles C. Kimball, Assistant Vice-President (in the credit department) of the Merchants National Bank, Boston, before the Massachusetts Society of Certified Public Accountants, Inc., November 23, 1936:

> "There is one practice, resulting in the customer's putting his best foot forward, which has the banker's hearty approval, and that is the use of the natural business year. In part, our reasons for approval are the same as the accountant's. In our credit departments we are overwhelmed with work from January to April, then there is not much analysis of statements after that time. The banker approves thoroughly of the use of the natural business year to spread the work more evenly. Beyond this . . . I think probably it gives us a better comparison if statements are presented to us at the time of least activity. That is, the comparison from year to year is less likely to be affected by seasonal influences at the low point than it is some time later in the year when the business is more active."

Occasionally, a banker expresses the idea that fiscal year reports disrupt comparisons—that credit conditions are associated with calendar years and it would be confusing to review statements for various fiscal years. In answering this it should be kept in mind that in few industries today is there a common closing date for all companies. Therefore, if the principle of the natural business year is adopted generally, all companies in the same line of business would have approximately the same closing date and comparisons between companies in the same industry could be more easily made. Also, so far as individual companies are concerned, it should be pointed out that monthly statements are now the general rule, so that even in the year in which the change is made it is possible to prepare comparative statements for the twelve months ending on the new closing date, and also for any previous twelve month period. The final answer is that statements prepared for a natural business year will furnish a more reliable basis for comparison. It is obvious, for example, that any development of standard ratios for specific industries would be affected by the extent to which the various industries had adopted natural business years. An instance comes to my mind wherein a banker raised a question with a customer about certain items in the financial statements not being in line with statements received from other representatives of the same industry. It so happened that the accountant was called in because he served all the members of this particular association. It developed that the customer in question was the only one who had not changed from a calendar year to a natural business year. Something which at first sight appeared unfavorable to the banker, upon investigation, proved that the original impression obtained from the calendar year statements was false. The uniformity which is to be desired, therefore, is standardized use of the natural business year principle.

The custom of closing books at December 31 not only puts a seasonal burden upon bankers, but the Bureau of Internal Revenue of the Federal government receives a cor-

respondingly large proportion of tax returns at substantially the same time. Widespread adoption of fiscal years would bring about a more equable flow of tax returns and tax receipts to the Treasury Department. As the natural business year program progresses, it would be appropriate to have a study made of the effects upon the Treasury Department of substantial use by business corporations of the natural business year principle including in such study the relationship of governmental receipts and disbursements, adjustments required in organization, procedure, personnel, etc. That the Treasury Department is not opposed to adoption of fiscal years is well known. It is interesting to note that Mr. Robert M. Cooper, collector of internal revenue for the district of South Carolina, stated at a meeting of the South Carolina Association of Certified Public Accountants held on December 10, 1937, that he strongly advocated adoption of natural business years, in order to avoid the heavy strain of the first three months of the calendar year. He indicated that each year it would become increasingly more difficult to grant extensions for filing income tax returns and urged business to solve the problem by spreading closing dates.

The Treasury Department has cooperated with the Natural Business Year Council by supplying currently information relating to changes in fiscal years. During the fiscal year ended June 30, 1936, according to information supplied by the Treasury Department, approximately three thousand taxpayers changed from the calendar year to a fiscal year. During the fiscal year ended June 30, 1937, somewhat more than three thousand three hundred changes were effected from the calendar year to a fiscal year. These changes substantially exceed the number of changes from a fiscal year to the calendar year. During the period of eleven months ended May 31, 1938, 2,689 taxpayers changed from the calendar year to a fiscal year. The high-water mark for any one particular month in recent years was June, 1937, when the Treasury Department approved 678 changes in accounting periods, 51 from a fiscal year to the calendar year and 627 from the calendar year to a fiscal year. It would be of interest if we could ascertain the details of all fiscal year changes approved by the Treasury Department such as industries affected, reasons given, etc.

Many corporations doubtless have been subjecting themselves to the risk of paying unnecessary taxes by failure to close their books at the end of their natural business year. The provision in the Revenue Act of 1936 relating to the surtax on undistributed profits forced business men to estimate the year's profits, and pay dividends accordingly, in advance not only of the closing date but in the normal case from thirty to ninety days in advance of the time at which the profits normally would be determined. If profits were estimated too high, dividends would be paid out unnecessarily. If profits were estimated too low, additional taxes would have to be paid which could have been averted. The likelihood of making errors in forecasting profits is lessened substantially at the end of the natural business year when inventories are low and profits generally are in their most liquid form and available for dividends. The surtax on undistributed profits appeared first as part of our tax system with the enactment of the Revenue Act of 1936. Those corporations which already were on a fiscal year basis found themselves better prepared to meet the new tax provisions than the calendar year corporations. In fact, it was this new feature of the tax law which forced many business men unconsciously to consider the seasonal characteristics of their business. Management

began to realize in its efforts to anticipate the year's profits, and in financing the payment of dividends, that perhaps December 31 was not the most logical date to close the books after all. The Revenue Act of 1938 contains substantial modifications in the undistributed profits tax. The principle is still there, however, and may be restored to its former status in future revenue acts. Or it might strike with even greater severity in the future because the previous provision, it will be remembered, was the result of compromise of wide differences of opinion. Corporations with seasonal activities should take steps immediately to adopt their respective natural business years, not only to obtain more informative financial statements, but also as a possible tax saving measure in the event of further burdensome provisions in future income tax laws whether in the form of a surtax on undistributed profits or otherwise. Disregarding the surtax feature of the income tax law, in those cases where inventories enter into the computation, profits determined on the basis of a natural business year—because ordinarily they would be based upon minimum inventories—are more likely actually to be realized than those determined on the basis of some other accounting period; and the importance of limiting taxes based on income to profits actually realized rather than permitting them to be levied on book profits which may never be realized will be recognized universally. Every opportunity should be availed of, therefore, to point out to industry the desirability in this connection of adopting the natural business year.

It happens that corporations which adopted a fiscal year prior to January 1, 1936, will benefit by having done so when one considers the effective dates of the Revenue Acts of 1936 and 1938 and the changes in general business conditions. The surtax on undistributed profits under the Revenue Act of 1936 did not affect fiscal year corporations until sometime after January 1, 1936, and varying portions of 1936 earnings for these corporations were exempt from the application of the Revenue Act of 1936. Similarly, the Revenue Act of 1938 will not apply to these corporations until the beginning of the next succeeding fiscal year after January 1, 1938, thus taxing varying portions of 1938 earnings under the Revenue Act of 1936. With the general trend of earnings downward in 1938, as compared with 1936, fiscal year corporations have been benefited accordingly. This point was made the subject of an article appearing in the Wall Street Journal of May 14, 1938, reprints of which have been prepared for distribution by the Natural Business Year Council, wherein is listed over forty well-known corporations with fiscal years ending from June 30 to November 30. It should be observed that the tax benefits thus received by many fiscal year corporations could not be foreseen and under other circumstances might have affected them adversely. The point is that the incidence of changes in tax laws falls on fiscal year corporations one to eleven months after calendar year corporations and in all instances fiscal year corporations have this much additional time in which to adjust their policies to meet the changes in tax laws.

International Harvester Company probably is the most outstanding example of a company which changed from the calendar year to a fiscal year since the inception of the present natural business year program. In 1936 this corporation changed to a fiscal year ending October 31. The published report for 1936 contains the following introductory comment by Mr. S. G. McAllister, President:

> "Heretofore the company's annual report has been based on a fiscal year ending December 31st, but including no sales after November 30th. This year and hereafter the annual report will be

for a fiscal year ending October 31st and will include all operations up to that date except for the major portion of the southern hemisphere where the accounts will be closed as of June 30th as heretofore.

"This change in the fiscal year involves a number of adjustments which are referred to in detail in the surplus account and in the certificate of the auditors..... So far as the income account for 1936 is concerned, it reflects the operations of twelve months in the major part of the southern hemisphere as heretofore and eleven months in all other places instead of twelve months, the missing month being November, which is normally a low month in sales.

"The change in fiscal year has been made because October 31st is a more seasonable date for most of the company's manufacturing plants and sales branches."

We sometimes hear it said that the activities of our largest corporations are too varied and widely scattered to adopt a fiscal year in lieu of the calendar year. This comment certainly is refuted when a corporation such as International Harvester, manufacturing numerous products and having plants in many parts of the world, selects a fiscal year.

The reference to the southern hemisphere is illustrative of the fact that many industries whose natural business year in this country is December 31, such as in most construction lines, would find June 30 the logical fiscal year in the southern hemisphere.

A year later the J. I. Case Company, manufacturers of farm machinery, followed in the footsteps of International Harvester by changing from the calendar year to a fiscal year ending October 31. In the published report for the period of ten months ended October 31, 1937, the following comments appear under the heading "Change In Fiscal Year":

"The Company changed its fiscal year from the calendar year to a year ending October 31. This date marks the close of the active selling season in the farm machinery business as farm activities are substantially completed by that date. On account of this change, results of operations are reported for the period January 1 to October 31, 1937, and future reports will be for periods of twelve months ending October 31 each year.

"Practically all of the Company's business is with the farmer, and is seasonal and subject to wide fluctuations in sales and earnings between months, as well as between years. The active selling period is the farming season (spring, summer and early fall) and the inactive period is the late fall and winter season when sales are normally light. On the other hand, the expenses of the business do not fluctuate in direct relation to sales, but are more or less uniform throughout the year.

"Because of this, results for the ten months covered by this report are not a reliable basis for determining earnings for a full twelve months. To illustrate this there has been included in this report an Income Account for the period of twelve months ended October 31, 1937."

Another prominent corporation to change recently from the calendar year to a fiscal year is The Aviation Corporation. In the 1936 report of this corporation Mr. L. B. Manning, President, addresses the stockholders as follows:

"The consolidated balance sheet and consolidated profit and loss statement of The Aviation Corporation and subsidiary companies for the fiscal period ended November 30, 1936, are submitted herewith.

"Heretofore the Company has submitted its annual financial statements on a calendar-year basis. The manufacturing subsidiaries and interests acquired by the Company in 1934, however, have operated on a fiscal year basis ending each November 30, and it has been considered advisable to change the fiscal year of the parent company to agree with the fiscal year of its subsidiaries, as November 30 conforms more closely to the end of the natural business year for the company's aviation manufacturing activities than the end of the calendar year. This change has been effected by an amendment to the By-Laws, and has been approved by the United States Treasury Department for tax purposes."

The most recent change from a calendar year to a fiscal year which has come to our attention is that of the Parker Pen Company which has

selected February 28th as its natural business year. This date is in keeping with another leader in this field, L. E. Waterman Company, which has adopted a fiscal year ending January 31.

The meat packing companies have long been known to operate generally on a fiscal year basis. October 31 is used by nearly all the representative meat packing companies, including Armour and Company, The Cudahy Packing Company, Swift & Company, Wilson & Co., and others. The Institute of Meat Packers writes as follows:

> "The selection of a year ending October 31 was brought about by the fact that at the end of October pork-packing companies have completed what they consider a normal cycle of operations. The marketing of hogs by live stock producers is a somewhat seasonal matter. The numbers offered for sale begin to increase in the fall and early winter usually reaching a peak in January or February; this is followed by a decline, a secondary peak in May or June, and very small marketings in July, August, September, and into October. The pork packer characteristically accumulates fairly heavy supplies of product in cure and storage during the winter months, with the expectation of marketing the excess during the summer, and reducing his inventories to a low point about the end of October.
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> "The seasonal character of pork packing is not quite so pronounced as it was a good many years ago, but it is still important enough so that all the larger operators figure their natural year as ending in the fall. By the end of December they have embarked on a new season of product accumulation, and naturally that would be a poor time for them to close their books. Many of the small local packers, however, keep their accounts on a calendar-year basis, as they are less affected by the seasonal variations than are the larger units."

Department stores, as has been mentioned previously, represent another line of business which follows in practice the logic of its natural seasons with obvious benefits. Almost any department store selected at random would serve as an example of a January closing, including the well-known store of R. H. Macy & Co. and its subsidiary, L. Bamberger & Co.

A representative industry which has not taken full advantage of the benefits of its natural business year is the automobile industry. Automobile sales are highest in the spring. Inventories are lowest in the late summer or early fall. Preparations for the coming season's model usually are commenced in the summer. An operating statement on a calendar year basis would include sales representing the latter part of one season's model and the first part of the succeeding season's model. It would differ from the "model" or budget year by several months. September 30 would appear to be the quarterly date which would most nearly coincide with the natural business year of the automobile industry. While a few of the smaller manufacturing companies, and some of the accessory companies, have adopted a fiscal year, the three largest manufacturers close their books as of December 31. A September 30 closing would bring the budget year and fiscal year closer together and would coincide more nearly with the "model" year. The practice in this and many other industries of taking inventories at their low points several months in advance of the calendar year is further indication that the calendar year probably is not as good a period for keeping the accounts as the natural business year.

Automobile dealers likewise should adopt a fiscal year rather than the calendar year, probably October 31. The National Automobile Dealers Association concurs in the selection of this date.

Another industry which has not taken full advantage of its natural business year is the dairy and produce industry. It has long been the custom of the milk business to make general arrangements for the purchase of fluid requirements on or about April 1 of each year. The early months of the year are the least

active and the financial position is then most liquid. It usually takes until March to dispose of surplus butter inventories. March 31 appears therefore, to be the natural business year for this industry. The American Association of Creamery Butter Manufacturers agrees with this selection. Dairymen's League Cooperative Association closes its books March 31, but two of the largest units in the industry, however, The Borden Company and the National Dairy Products Corporation, close their books December 31.

Our attention was directed in one instance to the absence of information relating to the fiscal year of public accounting firms. Inquiry was made, therefore, of twenty-five accounting firms having offices in the City of New York relative to their respective accounting periods with the following results:

Date	*Number*
March 31	1
April 30	3
May 31	1
June 30	5
August 31	2
September 30	5
October 31	2
December 31	6
Total	25

Of those firms which adopted a fiscal year, it appears that they are about evenly divided between those closing during the first half of the year and those closing during the last half of the year. In one case where the firm had adopted a June 30 fiscal year, we were informed that the members of the firm also used a June 30 fiscal year for personal income tax purposes. One of the two firms on an October 31 fiscal year indicated that a month or two earlier probably would be a better time to close. One firm at present on a calendar year basis is contemplating a change to a fiscal year and another firm on a calendar year basis indicated that a May 31 fiscal year probably would be more appropriate for its affairs.

With respect to accountants' professional societies, information as to the fiscal years of twenty-four state societies of certified public accountants for which information was available may be summarized as follows:

Date	*Number*
March 31	2
April 30	4
May 31	7
June 30	5
July 31	1
August 31	3
September 30	2
Total	24

The American Institute of Accountants has adopted a fiscal year ending August 31.

The natural business year principle has been endorsed by representatives of both the Securities and Exchange Commission and the New York Stock Exchange. Mr. Carman G. Blough, while Chief Accountant for the Securities and Exchange Commission, commented favorably on the advantages of the natural business year. Mr. John Haskell, Executive Secretary of the Stock Listing Committee of the New York Stock Exchange, indicated approval of natural business years in an address before the Rhode Island Society of Certified Public Accountants. Mr. Haskell said:

> "The exchange is interested in the present efforts of the Natural Business Year Council organized by representatives of the American Institute of Accountants, National Association of Credit Men and others to secure a more general adoption by corporations of a fiscal and accounting period which fits the seasonal current of their business. Although some groups, such as the department stores, have for some time used the fiscal year that is natural to their industry, and other important companies have recently followed suit, the great majority of our listed corporations still use the calendar year, whether or not it is appropriate to the cyclical flow of their operations.

"The exchange is not primarily interested in the advantages which the natural business year may bring to accountants and corporations in the way of savings and operating efficiencies. It is deeply interested in two practical advantages which its general adoption should bring to stockholders and the investing public. In the first place, annual reports prepared on the basis of a natural fiscal year should be more accurate and contain less factors of estimate, since the accounts are prepared and audited at the time that the Company's turnover is at its lowest ebb and its open transactions are at a minimum. Second, its general adoption should permit the publication of reports to stockholders at a considerably earlier date after the close of the fiscal period, since the independent accountants would be in a position to spread the great volume of work, now concentrated around December 31st, over the full year.

"Any practical policy of this nature which aims at more informative and prompt reports to stockholders can be sure of the support and sympathy of the committee on stock list."

What procedure should be followed in making a fiscal year change? From the point of view of the corporation a study of its past experience should be made to determine the seasonal characteristics of the business. This means ascertaining the monthly sales for at least five, and preferably ten, years past; inventories, receivables, payables, and wages are other factors to be considered. Fiscal years of corporations similarly situated should be considered. It seems preferable, however, however, to base recommendations as to changes in fiscal years on the experience of the particular enterprise. It is in this way that the maximum benefit of the natural business year principle will be attained.

Having determined the fiscal year to be selected, it may or may not be necessary to change the by-laws. The corporation's accounting period is not always specified therein. It usually will be necessary to amend the by-laws, however, with respect to the annual meeting of stockholders. From the standpoint of Federal income taxes, the routine is comparatively simple. The procedure has remained virtually the same since the Revenue Act of 1918. Federal income tax provisions relating to fiscal year changes of corporations are contained in sections 46 and 47 of the Revenue Act of 1938. Application for change in accounting period should be made on Form 1128 which may be obtained from any Collector's office. The instructions on the back of this form read in part as follows:

"An application for a change in accounting period from calendar year to fiscal year, or fiscal year to calendar year, or from one fiscal year to another fiscal year, shall be made on this form and forwarded to the collector for the taxpayer's district prior to the expiration of thirty days from the close of the proposed taxable year. The taxpayer, when advised that the application has been approved by the Commissioner, will thereafter keep books and make returns upon the basis of the new accounting period. A calendar year means an accounting period of twelve months ending on December 31, and a fiscal year means an accounting period of twelve months ending on the last day of any month other than December."

Information to be supplied by the taxpayer on Form 1128 includes: (1) dates upon which the books of account were opened and closed each year for the past four years; (2) dates upon which the taxable year began and ended as shown on returns filed for the past four years; and (3) reasons why the change in accounting period is desired. Experience to date indicates that any reasonable request for change in accounting period will be approved by the Commissioner of Internal Revenue upon the basis of information supplied by the taxpayer on Form 1128 without further inquiry or correspondence.

No Federal income tax return can be made for a period of more than twelve months. A separate return for a fractional part of a year is therefore required wherever there is

a change in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate returns are stated in section 47 (a) of the law as follows:

> "If a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year."

The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time, that is, the return must be filed on or before the fifteenth day of the third month following the close of the taxable year.

Corporations filing tax returns for a period of less than twelve months compute the tax in the same manner as if the return covered a full year. However, in computing the excess profits tax the adjusted declared value of the corporation's capital stock, according to its latest Federal capital stock tax return, is reduced to that proportion of the total which the period covered by the tax return bears to a full year.

One word of caution. If a change from a calendar year to a fiscal year ending the early part of the year is made, it is possible that a new revenue act will be adopted later in the year retroactive to January 1. Ordinarily this would not be a matter of great concern. However, with such innovations as the surtax on undistributed profits, contained for the first time in the Revenue Act of 1936, it is not a matter to be dismissed lightly. No relief was available to those corporations changing from a calendar year for 1935 to a fiscal year in 1936 ending, say, January 31 or February 29. The Revenue Act of 1936 did not become a law until June, 1936. Similarly, the Revenue Act of 1938 became a law in May, 1938, but applies to taxable years beginning January 1, 1938.

Copies of a mimeographed memorandum containing Federal income tax information relating to fiscal year changes of corporations may be obtained upon request from the Institute's offices.

Generally speaking those states requiring corporations to file income tax returns will accept fiscal year returns, where calendar year returns previously had been filed, upon notice that the Commissioner of Internal Revenue has granted permission to file Federal income tax returns on the new basis.

Corporations filing reports with the Securities and Exchange Commission must be guided by rule K A 5 in connection with a change in fiscal year. When the period between the old and the new fiscal year is less than three months, no special report for the interim is required. When the period, however, is three months or more, the rule requires a report for the interim which would be substantially the same in form as an annual report. If the interim is less than six months, the financial statements in the special report need not be certified, provided the company undertakes to file certified statements for the interim with the next annual report.

Coming a little closer to home, what part are we, as accountants, to take in the natural business year program? The thought occasionally has been expressed that we should not urge changes in fiscal years because we have a selfish interest in

the subject. I do not share this view. I think we are better qualified than any other group to be the missionaries for this cause and I think we should pursue an aggressive course accordingly, not because to take such a position will result in benefits to ourselves, but because we believe sincerely that in natural business year we have something constructive and helpful to offer to business. If it isn't going to benefit the other fellow or if we can't think of a better reason than that we will be benefited thereby, then we had better remain silent.

This is a program in which each of us, whether employer or employee, whether associated with a large or small organization, can take part, and every calendar year client, large or small, is a prospective convert to a natural business year. This is to a great extent a matter of education; we should not hesitate, therefore, to advocate the natural business year though the fruits of our efforts may not be apparent until several years hence. It is for this reason that many of us gladly devote time talking on the subject to students in our institutions of higher education. It is for this reason also that it pays to talk to junior officers and persons in charge of the accounting departments, because at some future date these individuals may be among the senior officers administering the affairs of the business. This subject is not just a theoretical one, as may be the impression of some, but it is an intensely practical one and the benefits are worth having all of us exert the necessary effort to take full advantage of the present program. Experience has shown that results are obtained according to the efforts made or, in other words, the interest displayed.

We should not lose sight of any opportunity for natural business year publicity. Several banks have inserted advertisements on natural business year in newspapers at the suggestion of local accountants. It seems to me we ought to have more of this type of publicity. Department stores, for example, could work up a very constructive advertisement relating to the application of the natural business year principle to their industry indicating the benefits derived by them and recommending its use to others.

We should be on guard for discrimination against fiscal year corporations because of local state laws or regulations. Experience has demonstrated that properly conceived and directed efforts usually are sufficient to correct such situations.

That accountants generally have an active interest in the subject is indicated by the fact that to June 9, 1938, 1,128 replies to a recent questionnaire of the American Institute of Accountants on the subject had been received from members. This is a return in excess of 20% which is remarkable in itself. Of the total replies received, 301 accountants reported 684 actual changes among their clients to the natural fiscal closing date.

It seems evident that this is a program in which all of us can participate and if properly pursued the adoption of natural business years will prove generally beneficial.

Public Utility Accounting

THE papers which follow were presented at the third of a series of weekly forum meetings devoted to subjects of interest to substantial sections of the membership of the Society, but not considered as of interest to a group large enough to justify their presentation at a regular meeting.

This meeting, held on April 20, 1938 at the Town Hall Club, was a round table session planned by the Committee on Public Utility Accounting to give a general survey of the characteristics and historical background of regulated accounting as it exists in the public utility industry of this country today.

The papers were independently prepared, and represent the information and opinions which the speakers desired to present. They are not a presentation of the opinions of the Committee as a whole, although five of the six are Committee members.

The Evolution of Public Utility Regulation

By KARL K. VAN METER, Economic Analyst

GOVERNMENTAL regulation of economic activity is of quite ancient origin. The Greek city states and the Roman Empire furnished numerous examples of regulation. One of the most striking of these was when Emperor Diocletian, in 285 A.D., issued a schedule of prices of over seven hundred commodities and services. Prices at the time were unsteady and had been rising on account of the debasement of the currency. The Roman government decided, in the interests of protecting the standard of living of the then "under-privileged and ill housed" to introduce price regulation.

It is proposed to review briefly the historical basis of the common law principle summarized in "Munn vs. Illinois, 1876," which is fundamental in the regulation of public utilities today. This will include the adoption of the doctrine of "just price" by the medieval church, the ordinances of the guild merchants and craft guilds from the eleventh to fifteenth centuries, the mercantilism doctrines which constituted the transition period from the medieval to the modern or early modern states, and, finally, the regulation of industry in the early American colonies.

The doctrine of "just price" was advanced by the medieval church which attained a certain degree of control after the fall of the Roman Empire. Everyone was required to join this church. One was not born into the church but was required to be baptised into it. The church had, regardless of denomination or sect, a system of laws and courts as well as armed means of enforcing its orders.

Certain doctrines were especially insisted upon: first, the church repeatedly warned men against the pursuit of wealth; second, the taking of interest was considered sinful; and third, and more pertinent to the subject under discussion, the church particularly insisted that all goods be sold at a "just price."

"Just price", simply defined, was that price which would cover the cost of the raw materials, purchased of course at a "just price," plus a just amount to contribute to the living expenses of the merchant or craftsman. In different language, it was almost the same as a fair return upon a fair valuation, after reasonable expenses.

The guild merchants and the craft guilds, operating from the eleventh to fifteenth centuries, were not so religious, but they liked to do the honorable thing when they could. These guild merchants consisted, as to membership, of all the traders or merchants and all of the master craftsmen in a little town. The master craftsmen were included because the craftsmen in a sense were merchants—they bought goods, put a certain amount of work into them, and then sold them again. They were thus in the business of trading as well as in manufacture.

The guild merchants outlined certain ordinances which were very similar to our regulatory procedure today. They established first the monopoly of the merchants. An ordinance from Southampton, in England, in about 1260, read: "No one shall buy honey, fat, salt herrings, or any kind of oil, or mill-stones, or fresh hides, or any kind of fresh skins, unless he is a guildsman." Today, we similarly enumerate the types of business which are considered as being affected with the public interest sufficiently to permit monopoly.

They next attempted price control. Again in Southampton: "The chief alderman and twelve sworn men, each month or at least four times a year, shall see that the price of bread and ale be well kept in all places according to assizes (price) of corn." They had a system of adjusting the price of bread and ale according to the fluctuating prices of corn—something like the coal adjustment arrangement of the light companies and the gas companies.

.The craft guilds followed the merchant or guild merchant and consisted of specialists. When there were several blacksmiths in one town, for example, they would work away from the general guild merchants organization and form a separate craft guild of their own. Then they would issue regulations to protect the quality of the service or merchandise and to control the price. Historians who have studied the ancient documents very carefully found both the guild merchants and craft guilds tremendously impressed by the teachings of the medieval churches with respect to "just price." An ordinance from the guild of white tawyers (workers in skins) in London, for example, read: "No one shall take, for working in the said trade, more than they were wont heretofore to receive."

It might be imagined that the enforcement of the price of ale or the enforcement of the charges for shoeing horses, or of some of these other products which seemed to be affected with the public interest, — from honey to salt herrings,—might in those days be difficult. But business activity was relatively very stable in those days. The supply and demand did not fluctuate as widely as some of the swings today, and so it was far simpler and more practicable to control the prices and quality.

The Assizes of Bread proclaimed in 1202 adjusted the price of bread with the fluctuations in the price of corn. After this regulation of the price of bread came an ordinance to regulate that other very important necessity of medieval life, ale; and the price of ale was thereafter tied to the price of corn. Meat, poultry, and fish prices followed. Then the charges of carpenters, masons, plasterers, and blacksmiths became the subjects of ordinances. The guilds gave way before the nationalism of the period which followed.

Mercantilism was the organization, in a sense, of a nation into a guild merchants or into a consolidation of craft guilds; just as the purpose of the guild merchants and craft guilds was to promote the welfare of the craftsmen and merchants in a given town, so under mercantilism nations tried to obtain the same advantages.

At first the regulations were very mild and consisted chiefly in the prevention of importations of so-called "foreign luxuries," but later mercantilism regulations became very onerous. In every quarter and at every moment the hand of the government was felt in the economic life of the people. There were duties on importations and duties on exportations. There were bounties to help certain trades; and there were punitive practices to retard other trades. There were regulation of prices, regulation of quality, and regulation of profits.

The objects of these regulations were at first ferries, hackmen, wharfingers, and innkeepers. Queen Elizabeth added to the list through the monopolies she granted to her various favorites. She granted monopolies in salt, iron, vinegar, lead, and paper, just to name a few. The public became so aroused by the constantly rising prices for the necessities of life that Parliament was forced in 1624 to declare all monopolies null and void.

The reaction from mercantilism led to laissez-faire (leave alone), or "rugged individualism" as we call it. Adam Smith published his "Wealth of Nations" in 1776, just at the time that many of the mercantilism restrictions and regulations were being withdrawn.

In the American colonial regulations, we seem to have inherited a great deal of the guild spirit that was transplanted in the colonies. Massachusetts in 1665, for example, regulated the price of corn, tobacco, beer, beef, and bread. Others of the colonies treated the mining of lead, salt, and iron and some manufacturers very much like we treat public utilities today, i.e., regulating prices, granting monopolies, issuing regulations as to quality, weights and quantities, and restricting profits.

The great test of the legislation which followed was in the "Munn vs. Illinois" case of 1876. This was in review by the United States Supreme Court of the Illinois Railroad and Warehouse Act, a law similar to the legislation passed in the middle western states above the Ohio river in the so-called "Granger Legislation Era." The Illinois law established a Commission to regulate the charges by grain warehouses in Chicago, and to regulate railroad rates in Illinois.

United States Chief Justice Watts' decision rested on the common law or customs and practices of the peoples developed through the centuries. He said: "It has been customary, in England, from time immemorial, and in this country from its first colonization, to regulate ferries, hackmen, bakers, millers, wharfingers, innkeepers, et cetera." He said that Lord Chief Justice Hale had made a distinction between property used privately in business, and property affected with the public interest, in a 1650 case involving a wharfinger in which it was held that the wharf and crane had become affected with the public interest and had ceased to be private property only. This was the origin of our phrase, "affected with the public interest" which is the principal test of a public utility today.

Thus, in 1876, for the first time in this country there was recognition and upholding of a statute to regulate in great detail the charges for such a service as warehousing. There followed the Interstate Commerce Commission Act of 1887 which carried the Illinois statute on to a national basis. Beginning in 1907, the various state commissions were remodeled along the lines of the Interstate Commerce Commission and additional types of business enterprise—the telephone companies, the gas and electric companies, the street car companies, private water companies—were added to the warehouses and railroads as being within the category of "affected with the public interest."

Characteristics of Regulated Accounting for the Public Utility Industry

By FRANCIS J. MCANANLY, C. P. A.
Associate Accountant, Public Service Commission

THE public service industry, with the exception of municipally owned enterprises, is privately owned but because of the essential character of the service rendered, it is "affected with a public interest." Therefore, these utilities are subject to regulation which in turn is subject to judicial review. The Legislature delegates to an administrative body the problem of regulating the industry effectively but the final determination of what the public interest requires rests with the courts.

Utilities enjoy certain rights such as a privileged use of public streets, an exclusive franchise and the right of condemnation. In return, the state imposes an obligation which requires the management to furnish safe and adequate service at just and reasonable rates without undue discrimination and unreasonable preference (1). Here we have the essence of public utility regulation. The character and kind of service is controlled, the income of the company is restricted and the public is protected from discrimination and undesirable practices.

In New York State, the Public Service Commission exercises jurisdiction over public service corporations through certain powers and duties delegated to it by the State Legislature. These powers are "general rules for the guidance of the Commission leaving to it merely the carrying out of details in the exercise of the powers so conferred" (2). Our interest in these powers concerns the accounting features of regulation, as expressed in the New York Uniform System of Accounts.

The first Uniform System of Accounts for gas and electric utility companies in New York State became effective on January 1, 1909. There have been revisions since that date with which we are not now concerned; our interest at this time is only in the present systems which became effective January 1, 1938. Of necessity, the discussion will be limited to the more important aspects of the accounts and their economic significance and classification.

Accounting has been recognized as a most effective tool in public utility regulation. Control is exercised through the classification of accounts, prescription of methods in accounting and instructions governing their interpretation.

The Public Service Commission is empowered by law "in its discretion to prescribe uniform methods of keeping accounts, records and books to be observed by public service corporations" and also "the forms of accounts, records and memoranda to be kept" (3). Its authority is plenary so long as the system is not "entirely at odds with the fundamental principles of correct accounting" (4).

The object of the regulatory body in requiring a uniform system of accounts is to keep well informed concerning the business transactions of the corporations subject to its jurisdiction so as to have figures available for use in fixing rates, authorizing securities, passing upon

(1) Public Service Law, State of New York, relative to gas and electric corporations, Article 4, Section 65.

(2) Interstate Commerce Commission v. Goodrich Transit Co., 224 U.S. 194, 211; and Kansas City Southern Railway Co. v. U.S., 224 U.S. 445.

(3) Public Service Law, State of New York, relative to gas and electric corporations, Section 66, Subdivision 4.

(4) Kansas City Southern Railway Co. v. United States, 231 U.S. 423, 444.

transfers of property from one company to another and in other matters which may come before it. This does not mean that the Commission may infringe on the sphere of management through the medium of accounts or accounting methods.

While it is conceded that the Uniform System of Accounts is a most effective tool in assisting regulatory bodies to discharge their functions, it must be remembered that the placing of items in prescribed accounts should not prejudice the final disposition of those items in determining matters before the Commission or the courts. The character of the item, not the account in which the rules required it to be placed, must govern in a final determination.

In formulating and preparing a uniform system of account, the facts concerning the industry should be expressed in a logical way and interpreted according to accepted accounting principles. The ultimate aim is to present an accurate historical record of the transactions of a utility company leading to periodic conclusions set forth in financial statements which can be relied upon.

In the report accompanying the first uniform system of accounts issued by the New York Public Service Commission (First District) which went into effect in 1909 (5), it was stated that the purposes of the system were:

1. To establish uniformity between all corporations of the same class.
2. To establish systems of account which would show clearly and accurately the specific source of all income and the purposes of every expenditure.
3. To state the fundamental principles according to which accounts should be kept so as to prevent the charging of items to wrong accounts.

The first concept clearly enunciated in the Uniform System of Accounts is the differentiation between "capital" and "income". Its definite purpose is to maintain the integrity of the capital and to ensure the proper recording and segregation of income. This distinction is made to express facts which bear on public interest and relate the dollars invested over a period with the dollars consumed in a period. This procedure is intended to distribute the burden of cost equitably over the consumers of different periods as service is used.

The term "capital" is used in the sense of property capable of yielding an income. This capital is subdivided into fixed capital, now called utility plant, and floating capital. The utility plant is of major concern to the utility. This capital, tangible or intangible, is its actual "stock in trade." Floating capital is used up currently and permits the continuous and efficient operation of the business. Together, fixed and floating capital make up the rate base of property used and useful in furnishing service upon which the company is, by law, entitled to a fair return.

The plant accounts, besides giving information as to the investment in property used in furnishing service, afford the basic data necessary for use in approving security issues, transfers of property and other matters.

Income is the economic benefit measured in monetary units received or accrued during a given period arising from the use of capital or the rendering of service. It reflects the economic increases diminished by the economic decreases for the current accounting period. A clear distinction is always made in utility accounting between operating income and other income.

Operating income represents the figure which is used to measure the fair return that the utility is entitled to earn upon the fair value of its

(5) Public Service Commission Reports, First District, New York, Vol. 1, July 1, 1907 to September 1, 1909—pp. 771-777.

property, owned or rented, through charges to the consumer. It is the remainder after charging the revenues received from the consumer for furnishing service with the proper normal operating expenses including consumption of capital.

Other income includes the economic benefits which accrue from property owned and not used in utility service, namely, non-operating or financial income. The sum total of utility operating income and other income is termed "gross income" from which the corporation is enabled to pay interest and dividends on the funds invested in the business and to provide for reservations out of income for surplus and contingencies.

The form of financial statements required by the Uniform System of Accounts is designed to show these distinctions clearly.

The balance sheet, a static statement of the company's financial condition at a certain date, stresses the importance of the plant account by listing it first on the asset side. On the liability side, the legal capital is shown as the first item. Investments and fund accounts are next on the asset side, followed by the current and accrued assets, which are matched against the current and accrued liabilities. Deferred items are grouped next on both sides and reserves and surplus appear last on the liabilities side.

The income account, a dynamic statement of the flow of the business, is subdivided into sections covering total utility operating income, other income, income deductions and the disposition of net income.

The connecting link between the balance sheet and income account is the earned surplus account which has its own group of accounts to reflect increases and decreases which are surplus items.

The present Uniform System of Accounts differs from preceding systems in several important features. The first provision which strikes attention is the requirement that after January 1, 1938 electric utility plant shall be recorded at the original cost thereof, including direct and reasonable overheads to the extent actually incurred. Original cost is defined as meaning the cost of electric plant to the person first devoting it to public service. Thus, property which cost the "A" company $100,000 when it was first installed and devoted to public service, if sold to "B" company for $150,000 must be recorded on "B" company's books at its original cost of $100,000 in the Utility Plant in Service account, with the segregation of the difference of $50,000 in an account Electric Plant Acquisition Adjustment, provided this difference represents a proper investment value (6).

Let us contrast this concept of Cost with the accountant's viewpoint which is well expressed by Dean John T. Madden of New York University when he says that "it is universally recognized that correct accounting requires that a company's accounts shall record the transaction of that company and shall truly reflect its own actual cost" (7).

And again, the accountant's understanding of original cost is expressed by the American Institute of Accountants (8) when it says:

> "The amount paid for assets by its present owners including the cost of subsequent betterments without deduction for depreciation."

The accountant has been concerned with the cost to the account-

(6) See Federal Communications Commission Telephone Division Order No. 7-C, June 19, 1935; also New York Edison Co. v. Maltbie, 244 App. Div. (N.Y.) 685; 271 NY 103.

(7) Brief for Plaintiff, p. 57—American Telephone & Telegraph Co. v. Federal Communications Commission, Federal District Court, 81, 366.

(8) Journal of Accountancy, May 1929.

ing company. The present Uniform System of Accounts breaks this cost into component elements, original cost and a difference figure to reflect the variation between book cost and the original cost of the property which is included in an adjustment account.

Through this classification of accounts, the Commission seeks to perpetuate the original cost of the property at the time it was first devoted to public service because it is contended that original cost is relevant as one element of value in rate case proceedings. It is an unchanging concept and presents an historical cost of property on a cost of construction basis from the time it was first devoted to public service. It can easily be maintained as a pure element unaffected by changing price levels and is said to represent an advance over some of the old mixed property accounts which included various elements of value. Its use is justified on the grounds that the consumer is more interested in the cost of the utility plant than in its cost to the accounting company. It is felt that the consumer and public should not be affected by a mere change of corporate identity, their concern being with the utility as an institution.

One might inquire why cost of reproduction is not recorded on the books since it is considered as an element of value in rate proceedings. Such a valuation might have economic merit and desirability as reflecting the changing price levels at a particular time. However, this element is of such changing character dependent upon fluctuating price levels that it would be most difficult to record and keep up to date.

In the recent telephone case (9) the Supreme Court upheld the right of the Federal Communications Commission to prescribe accounts to classify the utility plant investment so as to set forth the original cost (10) of the property used and useful in furnishing service. In other words, the Court upheld the propriety of original cost accounting. It is contended that this decision imparts legal value to this element. Fear is expressed in utility circles that this recognition may cement original cost as the foundation for a rate base. There is some apprehension over the disposition of the electric plant acquisition adjustment account which, as has been stated, includes the difference between the book cost and the original cost of property. In the same telephone case, the Court held that the Commission has no right to require the write-off of this difference if it is an element of value.

It appears that any disposition of this investment value will be subject to the character of the item. It might be retained as a permanent investment, amortized through operations or charged to income or surplus as circumstances warrant.

Another noteworthy feature is the requirement of a continuing property record. This record is not treated in the system of accounts but has its origin in legislative action which authorized the Commission to require any public utility company to establish, provide and maintain continuing property records of all physical property actually used in service and to keep its records so as to show currently the original cost

(9) American Telephone and Telegraph Co. v. Fêderal Communications Commission, 299 U.S. 232.

(10) The term "original cost" as defined in the Uniform System of Accounts for Telephone Companies, Federal Communications Commission, 1935, means "the actual money cost of (* * * *) property at the time when it was first dedicated to the public use whether by the accounting company or by a predecessor public utility.

of said physical property and reserves accumulated to provide for the retirement and replacement of said physical property (11). Orders were served on all companies requiring them to set up and maintain such records. The purpose is to facilitate and speed up rate case proceedings and furnish a basis for prompt action in passing upon security issues.

No attempt will be made to present the problems encountered in establishing a continuing property record of original cost as defined by the Commission but it might be helpful to indicate that an examination of some of the companies' books for the purpose of original cost studies will present groups of properties similar to the following:

Property wholly constructed by the operating company.

Property acquired as an operating unit or system by purchase, merger, consolidation, liquidation or otherwise, where such property was previously devoted to public service.

Property recorded on the books of the company at imputed values due to appraisals, estimated overheads.

Property recorded on the books in accordance with the orders of the Public Service Commission at the figures shown therein.

Property acquired from other utilities which was not previously devoted to public service.

The magnitude of the task confronting some public utilities in establishing original cost can be easily appreciated when one considers the investment figures of these properties recorded in the ledgers of the present and predecessor companies, which must be examined for original unit costs. Where no records are available, an estimate of original cost must be made. However, it is felt that once this continuing property record is established, it will be relatively easy to maintain.

In businesses affected with public interest, the matter of depreciation is of unusual importance. It concerns the consumer, the regulatory body, the taxing authorities, as well as the company, its insurers, and others. In establishing rates, depreciation and depreciation reserves are important elements. When a company asks permission to issue securities based upon its property, accrued depreciation must be considered. In purchases and sales of property, actual depreciation is a factor. Depreciation computations are involved in almost every problem of property or operating costs.

It is natural, therefore, that depreciation and reserves for depreciation find a place in the Uniform System of Accounts. The present system prescribes depreciation accounting. This is a decided change from the old system which prescribed the retirement method of accounting for property losses whereby provision was made for the equalization of property losses from year to year.

From an accounting point of view, the concept of depreciation deals with the return of capital to the company. That is, the purpose is to reimburse the company for the cost of the property as a cost of operations usually over the service life of the property. The definition of depreciation has been made to cover physical and functional depreciation but the method of computing the annual charge has been left to the discretion of the management.

It is not our purpose to review the concept of depreciation in detail but when depreciation is considered solely as an accounting problem, it can be simply stated. A utility invests its capital in utility plant and requires an investment in materials and supplies to furnish service and operate currently. The materials and supplies such as fuel and repair parts are consumed in a single operation while the investment in utility plant is consumed over a period of

(11) Public Service Law, Section 114 (1937).

time. Thus, the utility plant has the characteristics of a deferred asset waiting to be charged as a cost of service. This permits the allocation to revenues each period of the full share of related expense which includes capital consumed during the period. The purpose of depreciation is to maintain the integrity of capital and to prevent the distribution of dividends without regard to the decrease in value of this capital investment through any or all causes, physical or functional.

The Uniform System of Accounts clearly defines the component items of construction costs and permits the inclusion in costs of actual reasonable overheads, including interest during construction. For the purpose of simplifying the accounting for additions, retirements and replacements, electric plant property is divided into units of property and minor items of property. This division concerns retirement units and must not be confused with continuing property record units or appraisal units. The retirement units fix a dividing line between maintenance and depreciation accounting. A distinction is also made between property withdrawn in the ordinary course of business incident to operations and property sold as an operating unit or system.

Units of property are those items of plant which when retired with or without replacement must be credited to the property account with a concurrent debit to the reserve for depreciation of electric plant in service at the book cost.

Minor items of property retired and not replaced are credited to the property account and charged to reserve for depreciation. Where a minor item of property is replaced, the cost of replacement is charged to the maintenance account.

In this treatment of retirement units, the consumer is charged with the losses and receives the benefits of any gains through the reserve for depreciation.

The retirement of electric plant sold as an operating unit or system is accounted for by crediting the property accounts, clearing the related reserve accounts and including the difference as a debit or credit to surplus. In this case, the stockholder receives any benefits and is charged with any losses.

Of course, provision is made for replacements involving a betterment and minor variations. These comments are general, directing attention to the careful consideration given to the subject of accounting for property because of the diverse interests involved.

In the present system of accounts, capital stock expense is set forth in a separate balance sheet account implying that such costs are financial in character and as such includible in the return to the company in the same manner as debt discount and expense on bond issues. Previously, this capital stock expense was included in the utility intangible plant account "Organization" and considered of a permanent nature as long as the capital stock to which it related remained outstanding.

Another feature is the requirement that transactions with associated companies must be fully presented in appropriate accounts. The charges and credits must be entered first in a clearing account before being spread to other accounts unless approval is granted by the Commission of other treatment.

A review of the electric plant accounts will show that they have been developed along functional lines. Likewise, the operation and maintenance accounts are functionalized. However, depreciation is charged into operations as a composite account although the utility is required to keep supporting records to show the amount of depreciation charges by plant accounts. The amortization of the electric plant asquisition

adjustment figure chargeable to operations is also a composite figure as is the expense account "Operating Taxes". The revenue accounts are divided into classifications of service. Great difficulty would be experienced in allocating cost for any determination of cost of service.

The income account required by the Uniform System of Accounts clearly classifies the transactions of the business between the income received from consumers as a result of the rendition of service, operating income and income from sources outside the business, other income. This segregation of the income account divides it between items commonly said to be "above the line" and "below the line." Operating income represents what is left after the revenues received from furnishing service are diminished by the necessary operating expenses including depreciation and taxes. As previously stated, it is the figure used in comparison with a rate base to determine whether the return earned by the company is fair. Of course, the book figures for operations will be modified in a rate case proceeding according to the reasonableness, necessity or pertinence of the charge against the consumer. Operating income expresses facts which bear upon public interest.

Other income represents the financial section of the income statement and includes net income from non-utility operations, interest and dividend revenues and related expenses and other income deductions. The remaining net income is available for distribution as dividends, reservations of income for charges not provided for elsewhere, and contingencies. This section of the income account and surplus account reflects the stockholder's benefits from the company's operations.

It has been said that the Uniform System of Accounts reflects the particular theories of regulation held by the regulatory body at that particular time. This is true to some extent but the fact should not be ignored that the background of the Uniform System of Accounts is derived from years of practical experience in solving problems peculiar to the public utility industry from an economic, legal and accounting viewpoint.

Installment Sales of Merchandise By Public Utilities

By Edward A. Kracke, C.P.A.

THE auxiliary merchandising operations of public utilities are not a new activity; they have for some time been a recognized adjunct to the sale of electricity and gas, constituting a means of expanding the consumption of the primary product. And it is perhaps principally for this reason that the accounting in connection therewith has been accorded only a subordinate consideration. In instances, such sales of merchandise, when all the related costs of marketing are given full recognition, have been on a near "break even" basis, or even at an actual over-all loss, a result which would be regarded as being justifiable, (if the amount is not excessive) from the point of view of its representing a part of the commercial expenses of the primary activity.

This merchandising activity generally has increased of recent years to a point where it has passed the "negligible" stage; balance sheets often show the receivables and inventories of this auxiliary operation as relatively important "current position" items. It has in fact reached a point where further accounting refinement in dealing with the subject may well receive more attention.

In two respects, the accounting for installment merchandising operations has not advanced, in the

case of utilities, to the extent that it has generally in the case of strictly merchandising concerns—the treatment of the finance charge and the treatment of losses upon repossession of the merchandise consequent upon default in payment.

The finance charge, added to the cash sales price, generally varies as between a shorter or a longer period for payment, though such variances are not necessarily in any ratio on a usance basis. But largely no doubt because of the view that this activity was somewhat to be regarded as in the "necessary evil" category, and therefore something to be disposed of with the minimum of clerical expense, it has been general practice in the utilities field to consider the finance charge as an addition to, or an integral part of, the sales price, and therefore not justifying the labor involved in accounting for such charge as a deferred income item, to be absorbed into earnings over the period of the contract, on a "use of money" basis. This view may, however, become untenable when the amounts involved are no longer negligible. Where the investment in the receivables attains the stage where it requires bank borrowings, this practice may definitely mean that the cost of the latter, which is charged to earnings over the terms of such borrowings, is not properly offset in the accounts by the applicable portion of the finance charge, except of course where the financing takes the form of a sale of the installment contract.

The burden of a detailed "deferred income" accounting for the finance charge may be fairly recognized as being in fact a burden, and the practice of not deferring condoned in the "negligible" era, and perhaps even in an intermediate stage thereafter, where there is a conservative treatment of the merchandising profit through adequate provisions for the prospective vanishment of such profit, as well as the further expense of reconditioning, consequent upon repossession. Furthermore, there are cases where investigation costs and other additional expenses particularly attributable to the installment contracts may fairly be regarded as forthwith recoupable through the finance charge; in particular this may apply to instances of "break even" or loss operations.

Repossessions are often accounted for as ordinary returns of merchandise. They differ, however, in fact from ordinary returns because they involve the cancellation of the related and previously booked sales profit in a period usually considerably removed from that in which that profit (never realized) was taken up; other factors of difference, of course, are the forfeited payments (in reduction of the loss) and the merchandise deterioration loss (inventories being charged at a reduced value for the repossessed article). Subsequently incurred reconditioning expenses are usually separately charged.

Where this procedure is followed, the net results thus attained are largely without meaning; they are likely to show considerable fluctuations from month to month, and offer no helpful information for managerial guidance. Furthermore, of course, this manner of charging operations for losses only when they are finally experienced, instead of setting aside an adequate provision therefor out of profits when the sale is made is not conducive to conservative balance sheet valuation of the receivables.

The potential value of a reliable portrayal of the installment merchandising operating results from the managerial viewpoint is important. Particularly where this activity is definitely regarded as altogether a commercial burden to increase volume of electric and gas sales, where energetic appliance sales campaigns may be conducted and the

credit-worthiness of buyers not too closely investigated, there may be this need of an informative accounting control in order to afford a more satisfactory managerial control.

The operation of a simple but satisfactory procedure in the accounts for this purpose, a procedure based on current experience, need not be an involved matter. An experience loss ratio, may be determined, say quarterly, on the basis of the past two or three years results (the length of the experience term being determined as changing conditions may make advisable).

For such an experience-basis loss ratio, there may be used the percentage of the "Net Repossession Losses" to the "Liquidated Sales" The latter would comprise the net installment sales for the experience period, say three years, ("net sales" meaning only after deducting any ordinary new returns but not repossessions) plus the sales value represented by the balances in the installment receivables at the beginning of the period, minus the sales value represented in the installment receivable balances at the end of the period; this net amount would represent the sales which would have reached their final consummation in the experience period, either by being fully paid or cancelled by repossession.

The "Net Repossession Losses" would comprise the balances of receivables charged off on the repossessed accounts during the period, plus the reconditioning expenses for the period minus the credit for the reduced value at which the appliances repossessed are taken into inventories.

Under such a procedure, a repossession loss reserve would be established and maintained by current provisions based upon the application of the loss ratio to the months sales. This reserve would of course absorb all the current charges and credits of the nature above described as "Net Repossession Losses" leaving the balance in the reserve to contain a provision, on the loss experience basis, against the "unliquidated sales" represented by the installment receivables balances.

The "Net Repossession Losses" as above outlined might, for the purposes of statistical compilations be restated thus:

Net Balance of Account charged off representing:
  Original amount of sales—Debit. (a)
  Amounts paid in — representing the forfeited payments—Credit (b)
Reconditioning Expense—Debit...... (c)
Value at which repossessed appliance is taken back into stock, representing:
  Original inventory value, as charged to cost of sales—Credit (d)
  Amount of reduction in value by reason of deterioration in use—Debit .... (e)

From another viewpoint, the composition of the net loss might be restated thus:

Cancelled Profit on the repossessed sale:
  Sale (a) minus cost of sale (d) .... Net debit
Merchandise Loss:
  Deterioration (e) plus reconditioning (c) minus recoupment through forfeited payments (b)..... Net debit or Credit

Comparative statistics for the component loss items might be so arranged as to reveal helpful information concerning trends, as where the tendency might be to defaults in the earlier months of the contract, or increasing abuse of the appliance. As to the latter, there would, of course need to be a condition of stability in the basis of valuing the repossessed article.

In conclusion, it may be remarked, that in cases of fluctuating conditions, or pronounced changes in trends, perhaps a more satisfactory basis of making the monthly provision for repossession losses, in lieu of the application of the loss ratio to the month's sales, would be the determination of that amount which

would be necessary to have the balance in the reserve at the end of each month reflect the application of the currently determined loss ratio to the aggregate sales value represented in the total receivable balance at such date. In this way, the effect of changes in the loss ratio would be fully reflected in the reserve balance, as against the "lag" on the other basis, due to the fact that the amount of the month's sales would be considerably less than the aggregate sales value represented by the receivable balance. In the interest of conservatism, of course, care would need to be exercised against any resultant too early decrease in provision, where the loss ratio is declining.

Accounting Requirements in the Motor Transportation Industry

By NATHANIEL L. FISH, C.P.A.

THE Motor Carrier Act, 1935, approved August 7, 1935, provided for the regulation under the jurisdiction of the Interstate Commerce Commission of approximately 75,000 motor carriers of passengers and property in interstate transportation serving almost every city, town and village in the United States.

The Interstate Commerce Commission has set up the personnel and prescribed rules and methods to regulate an industry which has developed during the past decade and is at present one of the most active in the field of national utilities. The Commission is therefore to be commended upon the efficiency of the newly organized division, the Motor Carrier Bureau, in getting these motor carriers, particularly the truckers who are known as the rugged individuals, functioning under government regulation, controlling every phase of their operation.

The Motor Carrier Act, 1935, has given due recognition to the accounting phase, as indicated in the following sections of the Act:

> Section 220—Authorizes the Interstate Commerce Commission to require annual, periodical, or special reports from all motor carriers. It grants the Commission the right to prescribe the accounts and records and memoranda of the movements of traffic, and the length of time such accounts, records and memoranda must be preserved and authority to inspect and examine any and all accounts, records and memoranda.

> Section 222 S—provides penalties for non-compliance with the rules or orders in regard to accounting records. It also states that if an officer or representative of a motor carrier shall knowingly or willfully falsify, destroy, mutilate or alter any such report, account, record or memorandum, or shall willfully file any false report, account, record or memorandum, he will be deemed guilty of a misdemeanor and upon conviction thereof, be subject for each offense to a fine not less than $100.00 and not more than $5,000.00.

The Commission's first order affecting accounts, issued August 3, 1936, prescribes the minimum periods of retention for books of account, records, memoranda, reports and documents, and states conditions under which books of accounts, records, etc., may be destroyed.

The order of November 29, 1937, issued by the Interstate Commerce Commission, prescribes a "Uniform System of Accounts" for motor carriers to be effective on January 1, 1938. The "Uniform System of Accounts" issued for the motor carriers of property, as compared with the "Uniform System of Accounts" prescribed for the motor carriers of passengers differs principally in the operating accounts, which is necessary because of differences in the nature of the operations. In connection with this order the Commission announced that only motor carriers in Class 1 having average gross revenues of $100,000.00 annually, such average revenues being determined

by the average gross revenues for the three years preceding the effective date, will be subject to this uniform accounting system, since it regards it unwise to impose accounting systems on the motor carrier averaging gross revenue of less than $100,000.00 annually until it has funds which will permit it to appoint and locate in the field offices of the Bureau of Motor Carriers, accountants who can advise and help the carriers put such system into effect.

In analyzing the "Uniform System of Accounts", I shall only touch upon the accounts or procedure that I believe may be of interest to you.

The motor carriers are classified in the following groups:

Class 1—Carriers having average gross operating revenues (including interstate and intrastate) of $100,000.00 or over, annually, from motor carrier operations.

Class 2—Carriers having average gross operating revenues (including interstate and intrastate) of $25,000.00 or over, but under $100,000.00, annually, from motor carrier operations.

Class 3—Carriers having average gross operating revenues (including interstate and intrastate) of less than $25,000.00 annually from motor carrier operations.

Separate systems of accounts will be prescribed later for Class 2 and Class 3 carriers.

All the accounts defined in this "Uniform System of Accounts" must be kept by the double entry method. All entries in the accounting books and details covering accounts in the general ledger must be definitely supported by vouchers and other memoranda, and such memoranda must be retained for the number of years indicated in the order issued by the Commission. All expenditures must be definitely supported by vouchers, detail payroll data, receipted bills or other evidences of expenditures incurred.

The books must be kept on a calendar year basis and for each month (or four week basis) all transactions applicable thereto must be written up, posted to the general ledger and balanced. The motor carrier was expected, as of the effective date January 1, 1938, to open a new ledger showing the classification of accounts as indicated in the "Uniform System of Accounts" prescribed.

Any unit of property, including additions or betterments of existing property, having a cost not in excess of $50.00 or having a life of one year or less, may be charged to the appropriate operation and maintenance expense, and not to the property account. When operating property such as buses or trucks is purchased under any plan involving deferred payments, no charge may be made to operating property for interest. In the past many accountants included the finance charge in the cost of buses or trucks.

In a transaction involving the acquisition of any transportation system or portion thereof constituting a distinct operating unit, the purchaser must obtain from the vendor all available records and other evidence relating to the acquisition, construction and improvement of property acquired.

In computing depreciation, the straight line method is prescribed, except that the mileage method may be used for automotive equipment. In no event may the charges based upon the mileage method be less in any calendar year than the result from the application of rates based upon straight line method.

The Franchise account must reflect only the actual amounts paid to the state or political division thereof, together with the necessary reasonable expenses incident to procuring such franchises. When a franchise or permit is acquired by assignment, the charge to this account must not exceed the actual cost to the original holder. This will prevent pyramiding of franchise costs upon the purchase of motor carrier lines, and accounts for the Commission's action in the past in not approving the sales of certain motor lines.

The average motor carrier is not large enough to have an experienced accountant in its employ. The accountant in public practice will be called in by the motor carrier not only to install the "Uniform System of Accounts", audit its records and prepare its tax returns, but will be required to assist these carriers in submitting evidence at public hearings before the Commission to substantiate rates proposed, or in force. Financial statements and traffic data are required in filing applications for acquisition of new routes or to contest new applications at public hearings made by other carriers. Requirements as contained in the "Uniform System of Accounts" and Commission rulings released from time to time, may result in added confidence in the motor carrier on the part of the banker and the investor, and eventually release idle funds for further advancement of the motor carrier industry.

Comparison of the Uniform System of Accounts for Motor Carriers with the Uniform System for Electric Companies

By FRANCIS T. LAWLESS, C. P. A.

THE uniform system of accounts prescribed by the Interstate Commerce Commission for motor carriers of property seems to be closely patterned after the uniform system prescribed by the Federal Power Commission for electric utilities, effective January 1, 1937, but differs in some important particulars, which are interesting because the motor carriers system represents an effort to adapt regulated accounting to comparatively small business units.

General requirements:

The definitions given differ from those in the electric system in several ways, most of which seem to represent an effort to make the system capable of being understood by a small business man. Definitions are given of such things as current assets, current liabilities, additions and betterments.

The definition of book value as distinguished from book cost is missing.

The requirements as to the use of double entry bookkeeping, supporting vouchers, preservation of records, etc., are similar to those in the electric system, with a few exceptions.

The requirement of the electric system that all charges to the accounts shall be just and reasonable has been omitted.

There is a requirement, interesting because it is not thought necessary in the electric system, to the effect that the final entries for any month or four-week period shall be made within 60 days after the end of the period.

Opening entries:

Carriers are permitted to revise their existing books before transferring the balances of the accounts to new ledgers set up in accordance with the uniform system.

This provision is fair, but one wonders why the motor carriers are given a privilege which was not given to electric and gas companies.

Deduction of reserves:

In stating the balance sheet, the system for motor carriers requires that reserves shall be shown separately as deductions from the specific assets to which they apply. Reserves not applicable to specific assets are to be shown separately on the liability side. In the electric system all reserves are shown on the liability side.

Property purchased:

The requirement for recording purchased property at aboriginal cost is not present in the system for motor carriers, but no charge can be made to the property account for more than what would be the cost of similar property purchased new.

Operating property retired:

Separate procedures are prescribed for recording the retirement of operating property on which depreciation charges were accrued under the unit plan and under the group plan.

In the case of property under the unit plan the balance remaining in the depreciation reserve is closed out to a depreciation adjustment account, the balance of which is treated as a part of depreciation expense.

Depreciation accounting:

Straight line depreciation is required, as in the system for electric companies, except that the mileage method may be used on automotive equipment, provided that the resulting charge is not less than it would be if based on the straight line method.

Rented property:

Taxes payable by the lessee upon property rented or leased is chargeable to the operating taxes account by the lessee. This is contrary to the requirement in the electric system.

Cash:

This account bears a note to the effect that it shall be credited with the amount of checks or drafts transmitted to payees. (Apparently some of the truckmen have been using the paid checks received with their bank statements as the basis in writing up their cash disbursement books).

Franchises:

There is a requirement that when a franchise is received by assignment the charge to this account may not exceed the cost to the original holder thereof. This is the only place in the system where the idea of aboriginal cost appears.

Unappropriated surplus:

The surplus account is prefixed with the word "Unappropriated", and divided into unearned and earned surplus, instead of capital surplus and earned surplus as in the electric system.

Taxes and licenses:

Income taxes:

The selection of taxes to be excluded from the operating taxes account and included in the income taxes account (under income deductions) is different from that in the electric system, in that in the motor carriers' system:

> Federal and State capital stock taxes and stock transfer taxes are included in the operating taxes account (called "Taxes and Licenses").
>
> Gasoline, other fuel and oil taxes, and Federal excise taxes are included in the "Taxes and Licenses" account.
>
> Taxes on dividends are not mentioned.

Contributions of Public Utilities Accounting to General Accounting Progress

By HENRY A. HORNE, C.P.A.

THE subject "Contributions of Public Utilities Accounting to General Accounting Progress"—prompts the question "have there been such contributions?"

The answer seems to be definitely that there have been contributions and influences, even though none of them is of such importance as to be thought of as a new principle of accounting.

In these days the use of the words "principles of accounting" seems instantly to precipitate an open conflict.

Some of the disputants seem to forget that all the principles for all proper human behavior were comprehended in the Ten Commandments (only ten) which were written thousands of years ago. And also they seem to forget that the Founder of Christianity sponsored a codification of all the law and the prophets —which He expressed in only two commandments or principles of human behavior.

So, we may dismiss any regrets that we might have about admitting that the accounting methods which have been developed by, or for, public utilities, have not evolved any important accounting principles. Principles are few.

But it is a fact that the accounting for public utilities has been influential in determining the progress of general accounting. Some of the contributions may be dismissed, rather lightly, as mere variations in bookkeeping technique. Others, definitely, have been forward steps in the application of the principle of making a distinction in the accounting scheme between the capital investment, and the income which is the fruit of the use of the capital. One of the contributions has the unenviable distinction of having been of negative value, or of having been a deterrent to general accounting progress.

Those enterprises which now we speak of as public utilities have as one of their outstanding characteristics a slow turnover of the capital investment. Stated otherwise, they require a relatively large capital investment on which a relatively low rate of return is earned. In our early history the older European countries supplied, for the most part, the capital needed by our transportation enterprises such as the canal companies, the turnpike companies and the railroad companies; by the water companies; and by the gas light companies.

The investors in those enterprises naturally desired to be kept informed as to the financial health of their investments, and the historical record shows that the vigorous growth in professional accountancy during the last half century received much of its impetus from the British chartered accountants who came to this country for the purpose of auditing American railroads in which Britons had made large investments.

One accounting device which was originated by American railroad accountants and which has been adopted by business generally is the Accounts Payable Voucher Register. Merchants had long used a form of Purchase Register which was a book of original entry only, from which the Accounts Payable Ledger was posted. When payment was to be made to the creditor a statement was prepared from the ledger and the remittance was made in the amount shown by the statement. The railroad men adopted the time-saving routine of gathering together all the unpaid invoices from each creditor and making one document of them—which document was called a Voucher. This collection of items, thereafter to be treated as a unit, was submitted for approval and for authorization of payment and was entered in the voucher register—which was both the book of original entry and the ledger of unpaid vouchers payable.

Another similar railroad accounting method did not meet with general acceptance. The railroad men thought that a treatment which was good when applied to accounts payable, would be equally good if applied to accounts receivable. Those who are familiar with railroad accounting will recognize the name of the Bills for Collection Register. Outside of the railroad field it has had no acceptance. Practically every

business man wants to keep a separate ledger account with each of his several debtors.

The principle of conservatism in accounting was adhered to by many of the earlier public utility accountants. One railroad company which was incorporated in 1831 leased its property fifty years later for a term of 99 years. For the purpose of the excess profits taxes under the Revenue Acts of 1917, 1918 and 1921 it was necessary to make a determination of statutory invested capital. The principal asset was quaintly entitled "The Road and its Outfit". It was carried in the corporate accounts in the amount of four and a half million dollars, which also was the par value of the capital stock issued and outstanding. It was proved to the skeptical Bureau of Internal Revenue that the invested capital of the railroad was twelve million dollars and that amount was accepted by the Bureau for the determination of the excess profits credit. Over that period of fifty years, actual increases of fixed capital investment aggregating millions of dollars had been charged off to operating expenses or directly to surplus. Probably that was an extreme case, but conservatism was generally more highly esteemed than precision.

With the coming of governmental regulation, first by state railroad commissions, then by the Interstate Commerce Commission, and later by state public utilities commissions, the utility companies moved unto a prominent position in respect of precision in the application of accounting theory. There quickly developed a sharpening of accounting distinctions. Uniform systems of accounts were developed. It was recognized that those systems should embody the results of the best accounting reasoning and discrimination. In the basic principle of sharp differentiation between capital and income large advances were made.

It was recognized that the cost of construction of fixed assets should include all the costs which are known as "construction overheads", such as interest-during-construction, and also taxes, insurance, engineering, injuries and damages, administrative, legal, and miscellaneous expenses, that were incurred during the construction period and were related directly to the construction work then in progress. Applying the same discriminating thought which had made clear and definite the proper treatment of construction overheads, there was evolved the sound procedure of including in construction costs all receipts and expenditures connected with preliminary or trial operation of the property that was in process of construction. The proper application of that concept requires a definite determination of the date of beginning of normal operation, which is not always an easy decision.

Also, it was recognized that the discount or premium connected with the issuance and sale of funded debt obligations was definitely a function of the interest charge for the service of the debt. Theretofore such discounts and premiums had often been lumped into the fixed assets accounts.

The newer accounting required also a separation from operating expenses of the expenses connected with the issuance of funded debt and of capital stock. It was recognized that such expenses as lawyers fees for drawing mortgage indentures, and the costs of engraving and printing the bonds which represented the debt, were so similar to discounts that properly they should be lumped together with the discounts and amortized ratably over the bond term, as a part of the interest charge against income.

Also, it was recognized that the costs of issuing the outstanding capital stock constituted an Organization Expense which was not properly

deductible from income while the corporation was a going concern.

In a number of minor items the distinctions which were familiar to informed accountants generally with respect to prepaid expenses and to unearned income, were sharpened and provisions were made in the uniform systems of accounts for groups of Deferred Charges to Operations and of Deferred Credits to Income, all based on the soundest of reasoning.

In those distinctions between capital and income the public utilities took leadership, as has been stated heretofore. The field of cost accounting was developing rapidly at the same time, and the utility accountants were up among the leaders in this movement. Among the ideas which developed in this association was that of functional classifications of accounts, instead of what might be referred to as descriptive classifications. The utilities provided for a departmentalization of thinking as to the ways in which they rendered their service to the public, and they accounted for their incomes and expenses in accordance with such departmentalizations.

A slightly further development of the same thinking was a sharp distinction which was made between the principal operations of the utility on the one hand and all auxiliary or subordinate activities, on the other hand.

At the beginning of this paper reference was made to a contribution by public utility accounting which was of negative value in the progress of general accounting. What was then referred to was the precise distinctions which were drawn thirty years ago between income and surplus. This was definitely a left-handed contribution to progress, and accountants have not yet wholly succeeded in overcoming its harmful influence.

It is probable that the regulatory commissions were the active advocates of the requirements inserted in most of the earlier uniform systems of accounts, that all expenditures which when made were found to be payments of expenses incurred in a prior accounting period—should be charged to Surplus Account. But the utility accountants acquiesced, and rather elaborate schedules of subsidiary accounts for specified classes of Debits to Surplus and Credits to Surplus, were included in those earlier accounts systems. As a result, all through the earlier months of any fiscal year, a myriad of items, usually of no importance whatever, were carefully charged or credited to Surplus. They never appeared in any income account, either of the current year, or of any other year.

The idea of separating prior year from current year charges was wholly logical, it was the result of a straining after a theoretical perfection, but in the course of years it was recognized that in this imperfect world any theory which fails to accommodate itself to the imperfections of human behavior is itself badly at fault.

The accounts classifications now in use recognize that what are now given the face-saving name of "delayed items" may be included in the current accounts unless they are so large as to produce a distortion, in which case they may be entered in the Surplus account directly.

The safe and sane accountant has long held it to be highly desirable to use the Surplus Account only for recording the credit for the net income of each fiscal period, and the distributions to shareholders therefrom. For any other entry there must be adduced a very good reason. Slowly the accounting for public utilities is in that respect returning to the safe and sane procedure.

To sum up: It appears that public utilities have not developed any new principles of accounting, but they have taken a leading position in making definite distinctions between

capital and income by thoughtful analyses of all types of expenditures and receipts; they were often extremists in the matter of conservatism in accounting until precision supplanted such extreme conservatism; they have been up with the leaders in cost accounting in planning for functionalized classifications of accounts and in devising proper forms and terminology for statements; and they have developed some forms of accounting records and some bookkeeping techniques which have been adopted, with advantage, by general accounting. Among those techniques are developments in the use of accounting machinery — to the discussion of which an entire evening could be given, but which cannot have more than mere mention at this time.

Inventory Methods

ON APRIL 27th, 1938 the Technical Committee on Inventory Methods conducted a discussion on the general subject as one of a series of round-table forums. The discussion, led by the Chairman of the Committee, was entirely informal, the greater part being the questions and remarks of members attending the meeting. The extent to which the members participated in the discussion indicates to the members of the Committee the success of this type of meeting and the desirability of its continuance. Most of the discussion consisted of questions and answers and as it covered some two hours' time, will merely be summarized here.

Necessity for Inventories

Bookkeeping, as we all know, originated with traders and later spread to manufacturing, municipal, religious and financial institutions. For many hundreds of years the trader looked on his business as a series of isolated transactions. An account for one voyage would be opened and closed, an account for one consignment of merchandise would be opened and closed when that consignment was disposed of. Not many transactions were handled by the same man at the same time and he generally calculated his profit or loss on each completed transaction and his uncompleted transactions did not affect his determination of income.

While inventories were used occasionally and to a small extent in the seventeenth and eighteenth centuries, it was not until the time of the industrial revolution in the latter part of the eighteenth century with the break-up of the old guild and domestic handcraft system and the organization of the factory system that inventories became an element of prime importance in the determination of income. The division of labor, the improvement of processes, the use of mechanical power, the improvement and complexity of products, all of which were characteristics of the industrial revolution, made it necessary to carry larger and more varied inventories of materials and supplies. This tendency has continued at an accelerated rate up to the present time and as inventories have increased in quantity and variety, so has the accounting for them become more and more important in the correct determination of income.

The management and control of inventory is one of the major problems of most operating executives and in many industries it may be the determining cause of success or failure. To maintain an inventory which is adequate to the needs of an enterprise and yet does not represent an excessive investment is a problem which can be solved only by the application of the very best judgment to the most accurate records. There are many reasons for maintaining inventory. In a factory, sufficient material must be kept on hand to keep the machines running and enough finished or semi-finished material must be provided to meet the demands of customers who require quick deliveries. In a trading business, enough material must be kept on hand to provide a good selection and to guard against sudden demands.

It may be taken as a general principle that every change in the process and every extension or complication of the operating or commercial activities of an enterprise means a greater investment in inventory with the necessary consequence that inventory control and valuation becomes of more and more importance in a correct statement of the accounts.

Purpose of Inventories

In the days when the importance of inventory valuation was beginning to be realized, the primary purpose of an inventory was to find out the value of what was on hand and by a comparison of the net assets at the beginning and end of the period to determine or to check the amount of income. The determination of the net worth or the change in capital or the value of the business was the principal purpose of taking an inventory and the determination of income, while important, was more or less secondary. The present tendency is generally to emphasize the importance of the inventory as a factor in determining income and to make the balance sheet position an important but secondary feature. We do not take as dogmatic positions now as we used to on valuations of balance sheet items. We are generally more concerned with making certain that reasonable bases of valuation adequately explained and consistently carried out are used than with any attempts to state the so-called "real", "sound", "actual", "realizable" or other values.

We know that a basis of stating the assets consistently followed will enable correct income accounts to be prepared even though some of the balance sheet items may be carried on bases which are clearly out of line with current conditions. Items such as good will, rights to exploit natural resources, bond discount and certain types of deferred charges generally represent no realizable value but their statement in a balance sheet on some conventional basis will not distort the income account nor deceive the reader of the statement provided they are handled consistently and the facts are clearly stated.

So it is with inventories. The same inventory might be stated at three or four differing valuations under different inventory methods. It would be obviously wrong to use different methods in different periods as this would inject into the income account an apparent profit or loss caused by the restatement of the inventory when no actual transaction had in fact taken place. Changes in method always distort the accounts for one period and while, of course, changes must occasionally be made, they should be fully explained and the effect of the change on income clearly indicated.

In the days when records were not as highly organized as they are now, the operators of an enterprise were not, as a rule, sure just how much their profit or loss had been until an inventory was taken. Perpetual inventories, periodical partial physical inventory tests, current calculations of process losses and similar devices have been perfected only in the last thirty or forty years. At present it is, I think, safe to say that in well-conducted manufacturing or trading enterprises accurate running book inventories are the rule rather than the exception and large adjustments required by discrepancies uncovered in the taking of a physical inventory are comparatively rare. The use of calculating machines of all sorts, particularly those which compile and classify information electrically by means of punched cards, and the many improvements in the books and card records available for inventory purposes, have put the possibility of accurate book inventories within the means of almost every enterprise. This means a great deal to management in the control of inventories. Purchasing policies may be changed on the basis of definite information as soon as conditions change and operators are enabled to plan production and make requests for future material needs on the basis of actual facts.

Another minor but important use of accurate inventory records is the compilation of lists of surplus or obsolete material which should be disposed of. In an organization hav-

ing several branches or units, it frequently happens that one unit may have an excess of a certain type of supply which another unit may be in need of and substantial economies can be made by using material already in the warehouse of one plant to fill the needs of another. The investment in supplies which in some enterprises, particularly those situated in places remote from markets, is substantial, can generally be reduced or maintained at a minimum through the use of accurate records.

But all these accurate records and control of quantities and operations, while of the utmost importance to the management, do not get us very much further with our problem of valuation except perhaps to help us a little on the elimination of obsolete or excessive items in the inventory. If we agree that the present tendency is to emphasize the income account, then our problem is primarily the correct application of costs to sales. If cost is properly applied to sales, any materials not so applied must be in the inventory. Practically all of our various inventory methods have as their principal object the correct statement of income, as will be apparent from the more detailed sections of this discussion.

Inventories are becoming more and more a function of the income account rather than of the balance sheet. In many cases, we find that inventory reserves, used perhaps to satisfy the demands of the convention that no inventory be carried at higher than market, have been provided either from surplus or through a charge to income clearly set off from actual operations. In many cases, particularly where substantial inventories are carried, such a charge is reversed when prices rise from an abnormally low market level. Whether such a charge should be a surplus item or should be shown separately in the income account, does not seem to be a matter of great moment. What is important is that it should be distinguished from charges arising from actual operations and when such a charge is made, the corresponding credit in later accounts should be treated consistently.

What is Market?

The conditions necessary for an adequate and representative market were the subject of considerable discussion and while naturally no final conclusions were reached, the views of the members present seemed fairly unanimous on a few fundamental points. This whole question of the nature and applicability of market prices is one which is worth careful study and on which it might be well for the Society or some other representative accounting body to make some clear statement of such fundamental principles as may be found to exist. One requirement for a market on which there seemed to be a general agreement was that a sufficient volume of trade was essential to give the market price of any particular commodity sufficient validity to use for accounting purposes. Markets for basic or primary materials, such as wheat and other grains, metals, rubber, cotton and similar commodities fill the requirements satisfactorily. The market prices for most securities listed on the New York Stock Exchange are probably satisfactory for accounting purposes but this would not be true, say, of a security traded in over the counter where transactions occur infrequently and where there may be a spread of, say, ten points between the bid and asking price. Obviously the valuation of a large block of such securities should not depend on a price determined by the necessities of an individual seller or the opinion of an individual buyer.

The result of maintaining an open market in any commodity would seem to be that a consensus of those most qualified to judge is obtained

and this is impossible without a fairly heavy volume of trading. It is also possible that one particular organization might have so large an inventory of a particular commodity that its rapid liquidation would break the market if the price happened to be fairly high. The use of a market value instead of cost presupposes the possibility of liquidation at the market price. Whether an accountant should use a market price which he knows could not possibly be obtained on any rapid liquidation of the inventory, might, in some cases, become a serious question. The management or the accountant could hardly be expected to endeavor to anticipate the further loss caused by rapid liquidation but, on the other hand, it is quite possible that some statement might need to be made pointing out that while market quotations were used, no representation was made that such prices could be realized on the entire inventory. This brings up the further question of the advisability of dropping any reference to market prices or market values and describing either inventory or securities priced at market as being merely "at market quotations".

Another important question on which there is no very definite rule or practice is the valuation of process and finished goods. Is "market" on a manufactured product not directly comparable with other products, say, an electrical appliance, a vacuum cleaner or some similar article, the price at which the manufacturer sells it to the dealer or distributor? If varying discounts are given, is market the list price at which the article is sold? Can the manufacturer's price be used as a criterion of market value at all, or is the market value of such an article the replacement cost of the labor and materials required for its production? In other words, if the article is composed mostly of, say, three different metals and rubber, is the market price determined by the prices of those materials plus labor cost at the current wage rate?

These are rather difficult and complex questions and the answer may be that for this type of article the only method of valuation is at cost with a possible reserve if cost will not, in all probability, be realized. Here, again, is a question which has been raised and which seems to warrant further study.

Several members discussed the inherently illogical nature of the "cost or market, whichever is lower" rule. Without repeating the discussion, which was along lines which are no doubt familiar to almost every accountant, it was clear that the members believed the rule might be considered one primarily of expediency. It was brought out that conservatism in inventory valuation in the balance sheet merely transferred income from one year to another and inflated profits in years subsequent to the write-down.

Retail Method of Inventory.

There was considerable discussion of the retail method, the operation of which seemed familiar to most of the members present. One member gave an interesting description of the application of the retail method to a chain of grocery stores. He made it quite clear that the retail method was probably the only practical one in such a situation and tended to give correct annual, as well as monthly, income. There was some discussion on the applicability of the retail method to specific cases which added to the interest of the meeting but was confined to specific cases.

It was evident from the discussion that the members present had a thorough grasp of the principles and use of the retail method and undoubtedly gained something from their exchange of experience.

Various Methods of Averaging Inventories

The discussion on various averaging methods was probably the most interesting of the evening as it dealt with problems which were arising in industries which were either recently reorganized or which were unfamiliar to most of the members. Another reason for the interest in the discussion may have been that it centered on the wine and liquor industry. Several of the members present were well qualified to speak on these questions as they were either in the accounting departments of distillers or wine growers or had had experience in their audit. From the discussion it appears that in the liquor industry, particularly the production of whiskey, the increase in value due to ageing is so great that the cost, with the addition of carrying charges, is below its insurable value. Whiskey is classified by age and all the whiskey of one age class is averaged. In the discussion of carrying charges, it was brought out that interest was not considered by some distillers as a carrying charge and a member asked whether there might not come a time when the increase of value through ageing was less than the combined carrying charges and interest. It was suggested that while there might be difficulties in recognizing interest as a carrying charge in the financial accounts, a statistical statement showing the increase in value through ageing on one side and carrying charges plus interest on the other, might be of great value to the management as this would determine the point at which the increase in value was less than the carrying charges plus interest.

There was some discussion of the propriety of considering interest as a carrying charge and it was generally agreed that regardless of how it was treated on the financial books, statistically interest was a cost of carrying the ageing whiskey. A member brought out that some of the smaller distillers who generally sell their product in bulk are occasionally unable to dispose of their entire product in that manner and must bottle what they cannot sell in bulk. Here, again they occasionally must buy some whiskey to meet the demands of their customers for case goods and a member asked if the company's own production cost them, say, fifty cents a gallon and they bought some whiskey outside at $1.50, how the sales should be costed. It was generally agreed that the only correct method would be to average the entire cost.

A member brought out that among European wine producers it was customary to add interest as well as other carrying charges to the cost of ageing wine. Another member stated that in California the general practice among banks was to disregard inventory values of wine and to lend fixed amounts, say, fifteen or twenty cents on a gallon.

Averaging in the edible oil and fat industry was discussed and it was brought out that the general practice there was to value the inventory on a running average which, while it practically never was the same as the market price, always had a tendency to approach it. This method was particularly appropriate for such an industry as one fat or oil could so easily be substituted for another. It was brought out in the discussion that the methods used in this industry in Europe and the United States were substantially similar.

Last-in, first-out Inventory Method

An extended discussion of this method took place following a brief explanation of the principles involved. This will not be repeated here as the fundamentals of the method have been described frequently and are no doubt familiar to most members of the Society. Several members appeared to think that the first-in, first-out method more

nearly represented physical facts than the last-in, first-out method. It was brought out in the discussion, however, that both methods were what are known as "rules of convenience", that neither method corresponded or could correspond exactly with the physical facts, and that in many cases the physical facts were somewhat closer to last-in, first-out than to first-in, first-out. It was pointed out that the advantages of the method were more evident in certain businesses, being particularly applicable where the material was uniform and not subject to change in style or model and where the price of the basic raw material was subject to wide and frequent fluctuations.

The dangerous economic effects of stating profits in times of rising prices on the basis of increased valuations of inventories which could not be sold or liquidated was brought out and it was shown that any dividends paid from such apparent profits must result either in depletion of working capital or increase in money borrowed as the money for the dividend declared on the basis of an inventory profit could not possibly come from an inventory of substantially the same quantity of material as was on hand at the beginning of the period valued at a higher price at the end of the period.

The remainder of the discussion on this subject covered points which have already been quite fully discussed in other publications of the Society and it is not proposed to repeat them here. Much interest was shown in the progress of legislation on the question of last-in, first-out and while this legislation was not completed at the date of the meeting, a summary of the situation will probably be of interest to the members.

The last-in, first-out inventory method which has been an accepted accounting practice for many years and has been used in the financial accounts of a number of important industrial companies has been recognized in a limited way in the Revenue Act of 1938. Section 22(d) of this Act reads as follows:

"(d) Inventories in certain industries—

"(1) Producers and processors of certain non-ferrous metals:

A taxpayer shall be entitled to elect the method of taking inventories provided in paragraph (2) if his principal business is—

"(A) Smelting non-ferrous ores or concentrates, or refining non-ferrous metals, or both; or

"(B) Producing brass, copper products, or brass products, or any one or more of them, not further advanced than rods, sheets, tubes, bars, plates or strips.

"(2) Inventories of raw materials: A taxpayer entitled to elect, and who has so elected, shall, in taking his inventory as of the close of any taxable year beginning after December 31, 1938, of raw materials which are—

"(A) used in a business described in paragraph (1); and

"(B) not yet included in goods in process or finished goods; and

"(C) so intermingled that they cannot be identified with specific invoices:

treat such raw materials remaining on hand as being: First, those included in the inventory as of the beginning of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year, in the order of acquisition.

"(3) Tanners: A taxpayer whose principal business is tanning hides or skins, or both, shall be entitled to elect (with respect to any taxable year beginning after December 31, 1938) the method provided in paragraph (2) as to the raw materials (including those included in goods in process and in finished goods) in the business of tanning hides, or skins, or both, if so intermingled that they cannot be identified with specific invoices.

"(4) Inventories at cost: In the case of the application of the provisions of paragraph (2) or (3) all inventories of such materials shall be taken at cost, including the inventory as of the close of the preceding taxable year.

"(5) Election of method: The method provided in paragraph (2) or (3)

shall not be applied unless the taxpayer, at or before the filing of his return for the preceding taxable year, has filed with the Commissioner his election to have it apply.

"(6) Regulations as to change: The change to such method shall be made in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary to prevent the avoidance of tax.

"(7) Change to different method: An election made under this subsection shall be irrevocable and the method so elected shall be applied in all subsequent taxable years notwithstanding any change in the principal business of the taxpayer, unless with the approval of the Commissioner change to a different method is authorized, and then upon such terms and conditions and in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe."

The recognition of the principle is the important feature of this new section. This takes the place of Amendment No. 10 which formed part of the Act passed by the Senate and considered by the House and Senate Conferees which read as follows:

"The cost of goods sold during any taxable year beginning after December 31, 1938, may be computed upon the last-in, first-out basis if such basis conforms as nearly as may be to the best accounting practice in the trade or business and is regularly employed in keeping the books or records of the taxpayer; and the change to such basis shall be made for any year in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary to prevent the avoidance of tax. Any taxpayer who, for any taxable year, is permitted under the preceding sentence to change to such basis shall be considered to have made an irrevocable election with respect to such year and future taxable years and shall not be permitted to change from such basis in any subsequent taxable year."

The more detailed and restrictive provision finally included in the bill was not entirely satisfactory to the framers of the Revenue Act. Senator Harrison in referring to the amendment to Section 22 (d) as finally adopted stated in the Senate on May 9th:

"Great difficulty has been experienced in working out the new inventory provision, and it is realized that it is not an entirely satisfactory solution of the problem. However, a start has been made, and it is hoped that the Treasury Department will make a careful study of the problem so that improvements can be made in the provision at the next session."

The feeling that the amendment as drawn is not entirely satisfactory was also expressed by Senator King in the Senate on May 11th. Mr. King, in referring to a concurrent resolution designed to correct ambiguities in the language of the Section, said:

"Mr. President, this concurrent resolution relates to Senate amendment No. 10 as adopted in conference. The amendment was intended to permit the use of the so-called last-in, first-out method of costing sales by the smelting and refining, copper- and brass-mill products, and tanning industries.

"The language used in the amendment as adopted in conference might be construed as making this method available only to the tanners, excluding the two metal industries. The concurrent resolution seeks to correct this situation by inserting the same language with respect to the two metal industries as is used in respect of the tanners."

The concurrent resolution referred to by Senator King was not called up in the House of Representatives but it is generally understood that the whole question will be studied by officials of the Treasury Department between now and the next meeting of Congress in order to draw up, if possible, regulations which will carry out the intention of the framers of the Revenue Act and, if this is not possible, to indicate wherein Section 22 (d) stands in need of correction.

Although it is impossible not to agree with Senator Harrison that Section 22 (d) as it now stands is not entirely satisfactory, it should be remembered that this represents an attempt to recognize with both

justice to the taxpayer and safety to the revenue a difficult and complicated although essential accounting practice and we should rather praise the framers of the tax bill for having done so much rather than blame them for not having accomplished their task perfectly. This is particularly true as there is still ample time for corrective legislation or regulations to be drawn before Section 22 (d) becomes effective in 1939.

Conclusion

The foregoing is not intended as a transcript of what took place at the meeting on April 27th but indicates substantially the ground covered and the nature and scope of the discussion. It is hoped that nothing of importance in the discussion has been omitted and with the exception of the statement on legislation permitting the use of the last-in, first-out inventory method, nothing has been added. The discussion was participated in freely by a number of members who presented their points and asked their questions clearly and logically. The atmosphere was that of a friendly discussion and an endeavor was made to permit any member who so desired, to express himself on any point which interested him. An outline of points which might be discussed was prepared and distributed to the members present. It was recognized that all the points mentioned in the outline could not be covered, the purpose being more to suggest questions to the members than to present a definite program.

The Chairman of the meeting gave a short introductory talk but the greater part of the meeting was taken up with discussion. The Committee on Inventory Methods wishes to congratulate those responsible for the organization of these meetings on their success. They appear to be of great benefit to the members and should be continued.

For the Committee

MAURICE E. PELOUBET,
Chairman

Retail Accounting

ONE of the current series of eight open forum meetings of the New York State Society of Certified Public Accountants was conducted by the Committee on Retail Accounting, with Mr. Walter A. Lese, Chairman of the Committee, presiding. The meeting convened at 7:30 P. M. on May 4, 1938 at the Town Hall Club, New York City, following a dinner session held at 6:30 P. M.

The meeting was devoted primarily to discussions involving installment accounting, inventory reserves and unit control, although during the course of the proceedings there were considered or mentioned such items as internal auditing, carrying charges, tax matters and form of financial statements.

In each case, the general discussion was preceded by the presentation of the subject by a member of the Committee. The method of presentation, as arranged by the Committee, did not provide for the reading of formal papers, but, through the use of prepared outlines, for the development of the subjects in a manner that would lay the foundation for stimulating participation by the assemblage.

A partial transcript of the proceedings follows:

CHAIRMAN LESE: It is my pleasure to welcome you to this session of our Society's so-called "round table series" of technical discussions. Retail accounting and its ramifications have developed so substantially in the past fifteen years that accountants who serve retail store clients have found it necessary to devote a considerable amount of their time to independent study—which might be described as their "laboratory work." The obvious result has been that the field has become a highly specialized one, with resultant concentration of practice.

Nevertheless it is the earnest conviction of the members of this Committee that there would be a more pronounced and widespread interest in the subject if those who believe that they have no special interest in retail accounting were to give due recognition to the scope and types of accounting work which are performed as a routine matter in large retail organizations (and especially the department store) and to consider the numerous items of mechanical equipment regularly employed in such establishments. Thus, for example, insofar as accounting is concerned, in addition to the regular system of accounts we find the following in operation:

> First, the retail inventory system; second, other inventory control systems, including control of units; third, budgetary control systems covering purchases and expenses; fourth, installment account systems; fifth, social security and other payroll systems; sixth, cost accounting systems for alteration workrooms, restaurants, manufacture of draperies and slip covers, ascertainment of delivery costs, etc.; seventh, currency control systems; eighth, internal auditing systems.

One goal sought by every retail establishment is to obtain maximum turnover with a minimum of inventory without, of course, needlessly sacrificing sales. For one of the essential items in furthering this purpose, management requires statistical data currently, while "hot," otherwise these data lose value. When we couple this situation with the recognized fact that retail operations and control necessitate voluminous record-keeping, we reach the obvious conclusion that comprehensive internal audit operations are necessary. In the planning and development of such operations, including the preparation of the audit program, the accountant is in a position to render most valuable service to his

client. His experience must dictate where the internal audit stress should be placed— within the limitation of the funds allotted by the management—for internal audit operations.

It is most desirable that, because of its pronounced importance, we devote some time, either at this or at a future session, to the consideration or study of internal audit procedure for retail establishments.

Our plans for this meeting provided for the reading of short papers, to be followed by open discussion, on the following subjects: First, Installment Accounting; second, Inventory Reserves; third, Budgeting of Merchandising Operations and Expenses. Unfortunately, our speaker on the third subject was unable to be present, and we shall be obliged to forego his introduction of that subject. Thereafter, the members of the Committee will furnish their observations in respect to any problem or inquiry involving Retail Accounting.

* * * *

We are hopeful that those distinguished members of the retail store fraternity who are present will actively and freely participate in the discussion and, through their observations, information and reasoning, shed light on the subjects of the discussion. With their practical, supplementing our technical, knowledge, I am confident that this meeting will prove to be stimulating and effective and therefore most fruitful.

Gentlemen, our first speaker—Mr. Thomas F. Mowle: his subject, "Installment Accounting."

Discussion on "Installment Accounting"

By MR. THOMAS F. MOWLE

MR. MOWLE: The volume of goods sold on the installment plan has assumed a large proportion of total retail sales. Installment furniture houses have accounted for most of this gain, although department stores have been highly successful in increasing this type of business. These increases have been made by department stores through encouragement of budget and other types of installment accounts, as well as through the increased sale of soft goods on these terms.

Installment furniture houses, in order to meet this growing competition from department stores, have added a number of new departments of a "soft" nature, such as men's clothing, wearing apparel, dresses and others. These formerly were considered exclusive to department and specialty stores. The term "soft" is used to contrast with furniture or repossessible goods.

This trend toward departmentalization by installment furniture houses may soon result in a new and distinct type of store to be known as an "installment department store."

Increases in installment sales tend to develop problems of finance. The direct result is an increase in installment accounts receivable and the consequent freezing of large amounts of working capital. It is the financing and collection of these accounts which present the most difficult operations of the installment business and also most of the accounting problems.

For example, the terms of the customer's contract may call for the account to be paid in twelve monthly installments, but in actual performance the customer will undoubtedly take thirteen or fourteen months. This collection experience will vary depending upon the class of goods sold, type of store and the economic level of the customer. Installment collections are always sensitive to the least business recession, and payments are often skipped for a month or two.

Due to irregularity of payments, forecasting cash and finance requirements is a very involved problem.

Stores which lack sufficient working capital to carry large amounts of installment accounts usually finance the accounts through the issuance of commercial paper, or through establishing a line of credit with a bank. In some cases the accounts are sold to finance companies.

Installment sales are, for the most part, made on a conditional basis, the seller retaining full title until final payment is made. Since we now have various types of budget plan accounts which increase with added purchases, usually of "soft" goods, the conditional contract becomes inoperative in fact, although in theory it still is binding. A new type of budget account is found in the "letter of credit" plan. This plan allows the customer to purchase up to a fifty dollar or hundred dollar limit and provides for three or four installments. This is an intermediate form of installment account which ranks between a thirty-day account and the normal installment account.

Some installment houses permit monthly purchases in a budget account, provided such purchases do not exceed the original contract. Under this plan no change is made in the amount of the regular monthly payment.

Numerous problems are to be found in the handling of installment accounts receivable, both in opening the account and in cash collection procedure. The accounts receivable are kept in ledgers and differ from regular thirty-day accounts. In some cases they are numbered and filed in numerical sequence rather than alphabetically. These ledger cards vary in form, from simple ledger cards posted on regular bookkeeping machines to special ledger cards posted by cash register machines. The cards as a rule have space on them for credit information. Colored metal tabs are also used for credit danger signals.

Accounts are also segregated according to class of goods, such as furniture, clothing, refrigerators, radios, budget and others.

The big problem is in handling the thousands of monthly payments in the most efficient manner. Two systems of handling cash and posting ledger cards are favored. They are the "dual" system and the "unit" system. Under the "dual" system the customer's payment book is receipted and a ticket bearing the amount and number of the account is printed by the machine in one operation. The payment tickets are later forwarded to the customer ledgers and posted.

The "unit" system, on the other hand, provides for a direct posting to the customer's ledger card and receipt book in one operation. The cashier, under this system, is both a cashier and a bookkeeper.

Each system has its good points, although the unit system seems to be a bit slower, resulting from the necessity of locating the ledger card or, in some cases, searching for it when it is misfiled. Its advantage lies in the opportunity of comparing the ledger card with the customer's receipt book.

Finance companies have made use of tabulating equipment in keeping installment records. The customer's payment book with this system, consists of a pad of punched tickets. Some form of this system will no doubt be given some thought in the near future. Serious attempts are at present being made to reduce the bookkeeping costs of handling installment accounts but so far progress has been very slow.

Any discussion of installment accounting eventually must consider methods of treating loadings or carrying charges. These charges are added to the retail sales price, and the charge is intended to cover bookkeeping costs, interest on investment and collection costs.

Carrying charges are handled in three different ways. First, the carrying charge may be considered as

paid by the first installment and included in income; second, the carrying charge may be added to the account and included in income in the case of no down payment; third, the carrying charge may be added to accounts receivable and credited to an account called "unearned carrying charges." This deferred account is adjusted monthly to the income account. The last method is the most conservative. It would be a good plan for accountants to adopt this method of handling carrying charges.

Any discussion of installment accounts must bring up the treatment of repossessions. One method is to take back the goods and credit the account with its realizable value and charge the difference off to bad debts. Most stores sell repossessed goods to dealers in second-hand merchandise rather than place such goods in stock to compete with new goods.

While credit men seem to place great stress on repossessing goods, it is a debatable point as to whether a store might not gain more by writing off the loss and thereby eliminating a reputation for selling repossessed goods. The present trend toward selling greater amounts of "soft" goods on the installment plan is already reducing the amount of goods which can be repossessed.

Another problem arises when preparing a financial statement and that is the necessity for estimating a provision for bad debts on installment accounts. The loss experience of the store is usually the best guide toward providing such a reserve. This is a reasonable method as various stores sell to people in various economic levels. Department stores usually have a lower bad debt loss than furniture houses.

Some stores also provide for collection expenses where no carrying charge is made and merge it with the provision for bad debts.

In aging installment accounts the number of consecutive payments in arrears is of more importance than the fact that an account has skipped a few payments but is now paying regularly.

Installment houses prepare financial statements on the accrual basis, but for income tax purposes some of them report on the installment basis. This, in brief, is the payment of a tax based on realized gross profits as cash is collected. Accountants have not favored this method in the past few years mainly due to the fact that changing from the accrual basis to the installment basis incurs a penalty of paying double taxes for that year. Increases in the tax rate, year by year, have tended to penalize those stores which were deferring payment of taxes. However, stores which are expanding and deferring considerable amounts of unrealized gross profits, can use such amounts postponed through deferring taxes to good advantage in improving their cash position.

A reversal of the present trend towards higher taxes would, of course, make this method of reporting income more attractive.

In concluding, the following is a resume of the major problems presented: First, the financing of installment accounts. Second, the high clerical costs due to deferred payments. Third, the treatment of repossessions. Fourth, the difficulty of making accurate provisions for bad debts. Fifth, the treatment of carrying charges.

The purpose of my remarks has been to stimulate discussion at this meeting rather than to comment on technical procedures.

Treatment of Gross Profit on Installment Sales

CHAIRMAN LESE: Gentlemen, Mr. Mowle has now deposited the subject in your collective laps.

Merely to start the discussion ball rolling I shall offer a few observations. His discussion of the installment method relative to taking in-

come into account dealt primarily with the treatment of the carrying charges. We know, of course, that in connection with annual reports, the Securities and Exchange Commission requires the details of the methods used in accounting for income on installment sales and collections. That contemplates an explanation not only of the treatment of carrying charges but also of the method of treatment of the profit on the sale.

Mr. Mowle, I wonder if you would give us your experience as to the method of treatment of the gross profit by, let us say, department stores. We know, of course, that the regular installment houses employ an installment method, but we have also heard that many of the department stores do not use the installment method but take the entire gross profit into income for the year of the sale. Is that true, according to your experience?

MR. MOWLE: Well, you have to look at it from two angles, first, are you looking at it from the tax angle, or, second, the published financial statement angle?

CHAIRMAN LESE: Primarily from the latter.

MR. MOWLE: Installment houses, in preparing financial statements, use the same method as department stores do, that is, they take up the income in the year of the sale rather than deferring it. For example, when you are using the installment basis, this year's sale is spread over two or three years in recouping the gross profit, but in making up a statement they use the same method as you find in any other department store. Take your sales, figure out your cost of sales and arrive at your gross profit regardless of the year you collect your account. They offset bad debt accounts by usually reserving a large amount for bad debts and that usually takes care of any contingency on that angle.

Determination of Reserve for Bad Debts

MR. DAVID SIEGEL: I would like to have Mr. Mowle's opinion as to exactly how to determine the reserve for bad debts.

MR. MOWLE: Well, that is a rather involved problem and you get into a number of angles.***

CHAIRMAN LESE: Excuse me, I understood that I was the one to be heckled tonight. *** (Laughter)

MR. MOWLE: In answer to the gentleman's question, one method that I have seen used is to figure out the amount of loss sustained from installment sales, for example, over a three-year period, and get the ratio, say, to a year's sales and figure that as a basis, then, in addition to that, also age the accounts by the number of installments in arrears.

For example, I know of several stores with accounts over three months in arrears; they'll set up a three-months' reserve. After they set up this over-all reserve, any more than that they will work up to a seventy-five and even a hundred per cent. You can't work much closer than that, but I have seen statements in which they have as high as ten per cent of the outstanding, and some stores substantiate that by saying, "Well, we had to provide for suspension expense rather than actual loss on the accounts."

There then followed discussions dealing with repossessions and systems of collections employed by chain store organizations.

MR. CHANDLESS: May I go back to the beginning and make a statement in reference to the experiences, say, in setting up a reserve for bad debts?

Now, in installment business, if you base your estimate on bad debts for an experience, you will find the figures are absolutely wrong. I have had a little experience in installment business, in fact, in very big organizations, and we found that the best

method in getting the bad debts is by separating the accounts receivable into three sections, one section known as "good," the other known as "suspension," (in other words, it is not bad yet) and the third section, "bad accounts."

Now if you sell, let us say, an article (taking a very simple case) and it is supposed to average over twenty weeks, that means that you will have to collect at least five per cent. Now if you discover at the end of the month, going through the accounts, that the customers have not paid within four weeks, they set that aside as a suspension account, and if at the end of the year they discover they haven't paid within two months, you set that aside as a bad account and write that off for tax purposes. That has been recognized by the Department.

Now if you tabulate that at the end of the year you will find that the percentage from year to year varies. You will find some years the collections are low and the sales are high, so if you base your percentages on sales in depression periods—over three years in these times—your figures would be very very wrong. Now if you use that method with the actual records of the accounts you will get more exact figures.

Tax Aspects

CHAIRMAN LESE: We don't of course desire to tread on the ground of the Society's Committee on Federal Taxation, but two points have been introduced in the discussion dealing with Federal taxes and I think they should be amplified somewhat. Was it stated that a taxpayer, reporting on the installment basis, is permitted to claim a deduction for additions to a reserve for bad debts?

The reason I ask the question is that it is my recollection that the Department does not permit such deduction.

MR. MOWLE: One only may deduct the cost of the goods sold, but if you deduct the actual bad debts and set up schedules, I have found that the Department will not trouble you; however, if you set up reserves you will probably run into trouble.

CHAIRMAN LESE: The other point I have in mind is Mr. Mowle's reference to the requirement that there be taken into income the amount of profit on installment collections by a taxpayer who previously reported on the accrual method and changes his method of accounting.

We all know, of course, that this is a requirement for shifting from the accrual method to the installment method. I wonder if Mr. Mowle would care to amplify the statement.

MR. MOWLE: When you swing from an accrual basis to an installment basis you pay a tax on the accrual basis and then you also pay on the collections. That is, for example, when you suddenly swing over, you're going to have accounts which started, say, in 1936, '35 and '34 and you'll pay a tax on those collections when you swing over as well as on the accrual basis for the year you are working on, and that is, in effect, doubling up, and unless you have a very small income for those years it is quite a cost to swing over.

There is another phase from the tax angle in figuring out the profits. They tend to jump up in years when you have a loss. You would normally have a loss on the accrual basis. For example, in 1936 you might have very heavy sales, then in 1937 you have smaller sales. On the book basis you would have a large profit in 1936 and practically none in '37, but your taxes wouldn't run that way. In 1936 you would pay a small tax, then in '37 you would probably triple your taxes as contrasted to the accrual method to swing over.

Carrying Charges

MR. WAGENBACH: In connection with the carrying charge, you say it

is more conservative to defer the income from the carrying charge, yet I think it is the practice in department stores generally to refund the carrying charge if the total account is paid within three months.

Now isn't it making an awful lot of work and bookkeeping to defer the income from month to month and then refund the carrying charges.

MR. MOWLE: The easiest method to handle that would be to throw the month's carrying charges into one account and then, if you are charging, say, one or two per cent, you can find out what your receivables are for that month and transfer the difference to income. You only have to make one adjustment a month.

This method is in use in some stores and I think it is conservative. You can see that twenty or thirty thousand dollars can swing one way or the other. I think accounting authorities are swinging over to the more conservative method of deferring.

MR. WAGENBACH: What would you consider the most practical method?

MR. MOWLE: I'd say, from my experience, that they are gradually swinging to the deferring method.

Deferred Gross Profits

MR. YOCIS: Mr. Chairman, may I ask one question? My last experience has been in connection with jewelry installment houses and chain stores and there was quite a problem involved in analyzing cash receipts and returned sales because, over a period of years, you create a number of unrealized gross profit reserves because certain accounts in 1932 or '29 might still be outstanding, and naturally you keep the unearned gross profit open; it is necessary to analyze your cash receipts, so as to ascertain the years to which they apply. The same is true for return sales and accounts receivables.

All this presents a big problem. For instance, if the account comes in from various stores to a central place for posting, it is very difficult, for the customer may have bought during two or three years.

Is there any new way of treating that at the present time or do you still have to go through the long procedure?

MR. MOWLE: One method we find most practical is not to carry on these unrealized reserves for four or five years. We use a sort of arbitrary way of figuring gross profit for those years by taking all accounts past '32 and merging them into one group.

MR. YOCIS: But you still analyze the accounts receivable, don't you?

MR. MOWLE: We analyze them at the end of the year. We just note the change in the beginning and ending balances. You can get it very quickly by using two sets of trial balances.

Discussion on "Inventory Reserves" Presented By Mr. Herbert G. Evans

CHAIRMAN LESE: Our program now provides for a discussion by Mr. Herbert G. Evans on the subject "Inventory Reserves."

Mr. Evans comes to us not only as a member of our Society but also as a department store executive.

MR. HERBERT. G. EVANS: Inasmuch as our time is limited I will not attempt to go into any great detail in connection with the subject "Inventory Reserves." Perhaps, however, with the subsequent discussion, we may be able to agree as to their necessity and methods of determining the same.

The reserves we may normally expect to find or provide on the records of a retail organization are as follows: Reserve for cash discount, reserve for loading discount, reserve for foreign exchange profit in inventory, reserve for inventory shrinkage, reserve for anticipated mark-downs

in excess of normal. All of these may not be necessary but they should be considered at all times.

Taking these reserves in the order enumerated, the first is "reserve for cash discount." Cash discounts are usually more or less in the nature of trade discounts and it is preferable to eliminate them from the inventory. They are not actually earned until the merchandise is sold. The average rate of departmental discounts received on purchases should be determined and applied to the respective departmental inventories to determine the amount of reserve required.

Loading discounts are sometimes used to equalize discounts. Wherever used they should be eliminated from the inventory departmentally, the same as cash discounts.

Foreign exchange profit in inventory should be eliminated where foreign purchases are substantial and when a standard rate of exchange, usually higher than the actual, has been used with a resulting profit on exchange.

Reserve for shrinkage will not be found necessary where inventories were taken on the last day of the period. When, however, inventories are taken prior to this date, as is often the case with department stores, reserves for inventory shrinkage from the inventory date to the end of the period should be provided.

Reserve for mark-downs. The necessity for such a reserve remains a debatable question. Under the retail method of inventory, the application of the complement of the percentage of original mark-on to the inventory at selling price gives us an inventory at cost, and in those cases where the original selling price has been reduced, an inventory at less than cost.

Before going further I should like to make it clear that the advisability of reserves of this type are not sponsored solely by practicing accountants. In June, 1937, at a meeting of the National Retail Dry Goods Association, the following proposal under the heading of "Reserves for Anticipated Mark-downs" was made:

"Under the retail method, the procedure for valuation of inventories is to reduce the currently market retail prices by the departmental percentages of mark-on.

"The basis for a reserve for markdowns in excess of normal cannot be definitely stated in formula fashion, nor can any arbitrary or uniform rules be given. The individual situation of each store will determine the necessity for the provision and the basis. As a guide, however, the Committee recommends that due allowance be made for the following conditions:

"1.— Age and Character of Merchandise. Amount to be set up to be based on difference between normal markdown allowances and the amount that will have to be taken to move such stock, as estimated by virtue of past experience.

"2.— Mark-down Experience on Former Inventories. Reserves should be set up on current inventory in accordance with per cent of mark-down experience developed on former inventories (exclusive of current purchases.) An analysis of mark-downs will very likely disclose a higher ratio of mark-downs taken on inventory than on current purchases. Appropriate reserves should accordingly be provided as disclosed by such analysis.

"3.— Percentage of Excess Purchases in Stock. When by virtue of past experience, stock on hand is in excess of the quantity that normally should be on hand at the close of the season in each department, due provision should be made for mark-down in excess of normal.

"4.— Shopworn and Obsolete Merchandise. The basis of providing the reserve should be the age and condition of such merchandise. The Treasury Department recognizes that current market prices are often not real, particularly in the case of shopworn, obsolete, deteriorated and similar type merchandise, including goods taken in exchange, and permits the valuation placed thereon at prices at which it is felt such merchandise will move, but in no case shall the value be less than the scrap value."

The important thing to us about these comments is that they represent the considered judgment of a group of department store controllers who have made a study of the matter and have come to the con-

clusion that the retail inventory method is not self-sufficient under all circumstances.

As is mentioned there, the method of setting up such a reserve is entirely conditional upon the store and the circumstances. No formula as yet has been determined.

A study by the University of Pittsburgh of mark-downs gave some interesting conclusions which I would like to read:

> "Merchandise which had been in the store more than a year lost forty-five per cent of its original price. The decline in price varied from twenty-nine per cent to seventy per cent; in general, merchandise having a strong fashion element declined the farthest. Merchandise of a staple character declined the least.
>
> "Merchandise from Season C (seven to twelve months old) declined approximately one-third of the price at which it entered the season.
>
> "Merchandise from Season D (thirteen to eighteen months old) declined about forty-five per cent from the price at which it entered the season.
>
> "Merchandise from Season E (nineteen to twenty-four months old) and from Season F (twenty-five to thirty months old) declined between forty-eight and sixty per cent."

These statistics indicate that the retail method does not give us the inventory value at which we should carry it on the balance sheet. The method, as I say, is still a question.

At this point in the proceedings there followed a brief discussion of the retail method of inventorying. Incidentally, this discussion disclosed that substantially all of those present had a knowledge thereof.

Adjustment of Book Inventory

FROM THE FLOOR: How often, in your past experience, would you adjust the book inventory with the physical inventory during the course of a year?

MR. EVANS: I think that semi-annually would be acceptable.

CHAIRMAN LESE: Has that been your experience, Mr. Mowle?

MR. MOWLE: I find it is true except in departments, for example, like women's dresses and things where you sell out a line, say, in a month. In that case they would start to adjust the inventory at that time.

I would say that Mr. Evans' answer is substantially correct because that would only apply to three or four items.

CHAIRMAN LESE: Of course with departments employing the unit control method, we find that inventories are taken currently (at least once a week) and therefore they always have a statement as to their actual position. I think that when Mr. Evans said "twice a year" he had in mind the departments that do not use unit control. I believe the experience in recent years shows that if we were to express it in terms of percentages, at least eighty per cent of the large stores take physical inventory twice a year and adjust their records to conform to those inventories.

Unit Control

FROM THE FLOOR: Is the unit control method in addition to the retail inventory method, or does it take the place of the retail inventory method?

CHAIRMAN LESE: It supplements the retail inventory method.

MR. GREENBERG: In connection with the previous question, I was going to suggest a brief exposition of the unit control system. I don't know whether everybody here understands that.

CHAIRMAN LESE: How about one of our visitors? Mr. Wagenbach.

MR. WAGENBACH: Unit control is an inventory system that is used both for accounting and merchandising. A buyer or a merchandise manager, from his unit control, can tell the number of pieces that he has in style, color and other pertinent information. It is supplemental to the general inventory methods.

Some have the thought that too much time is being spent on unit control, in that merchandise people worry so much about unit control records that they forget the merchandise. I think the trend is for a limitation of unit control especially while the so-called "hard times" are with us.

FROM THE FLOOR: What was just stated about the unit control being overemphasized is true; however it is found to be very practical in the higher priced lines, in the specialty and department stores.

FROM THE FLOOR: I'll grant you that, but I think there is a place for it and a very important place for it.

FROM THE FLOOR: I'd like to know of a substitute for it.

MR. WAGENBACH: In high priced articles, it is absolutely necessary, but in real turnover articles I don't think it is necessary.

CHAIRMAN LESE: I think at this point possibly we can have observations from a few of our merchandising experts, or store experts.

Mr. Goodfriend, can you give us your experience with unit control?

MR. GOODFRIEND: In department stores, furniture control is probably the major control that is kept. There is absolutely nothing like it for value. In the first place, no furniture buyer can know exactly what his stock is in a department store without reference to control records. Usually department stores carry from three hundred thousand to probably close to three-quarters of a million dollars' worth of furniture merchandise. Obviously, therefore, the value of a furniture unit control is beyond any doubt. None of us can actually get along without it. Otherwise, we wouldn't know the nature of our stock, or where it is placed (because of the vastness of its size). We have to have records with information of that type.

Along other lines of unit control, well, it may be true that it is a little burdensome. We try to make it a practice to have ready-to-wear lines kept by the buyers themselves and even in certain other small wear lines, so that we have no difficulty whatsoever.

FROM THE FLOOR: It seems to me that unit control is one of the most important things in the retail business.

If any executive buyer tries to run a retail business without unit control I would sugest he close his store, because from my experience I have learned that a buyer cannot run a business without unit control.

Now if you run a store with a definite merchandise price range, you have to buy in accordance with the percentage sold in each price group in order to keep your stock in balance and in order to invest your capital properly in proportion to the amount sold in each group. This requires unit control. You must know your styles, your good selling numbers of your styles, sizes, etc. You will find possibly in your clothing line that more will be sold in sizes 37 to 42 than below that. If you buy a lot of stock in sizes below 37, you will have idle capital and will pay insurance and interest and all that.

I have had many talks with the buyers of a very large department store. They cannot run their business without unit control; running only an inventory in dollars and cents would not be very helpful.

If you have had any experience with your buyers you will find they will tell you they must have unit control. It is to guide the administrative judgment of the buyer; that is what unit control really means.

CHAIRMAN LESE: It seems to me that someone must come to the rescue of Mr. Wagenbach. I am confident that when he gave us the opinion of unit control systems held

by some individuals, he was not thinking exclusively in terms of furniture departments and ready-to-wear departments—the two examples which have been given us here. He probably was more mindful of efforts made to establish unit control, for example, in such departments as men's furnishings. I think that we would all agree that to carry it that far would be wasteful unless you merely control types of articles by classification, as, for example, shirts, in total. To go beyond that, however, would seem to be wasteful, and as I stated, I am confident that we agree with Mr. Wagenbach in that respect.

Have any of you gentlemen any additional questions?

FROM THE FLOOR: May I make a comment? A good buyer doesn't have to look in a book to find out what colors are going over; he's got that at the tip of his fingers if he knows his job. A good buyer gets that the first thing in the morning from his lieutenants. (Laughter)

MR. GOODFRIEND: In some of our departments, of course, like a house furnishing or china-ware department, unit control is not really kept in the true sense of the word. We have certain kinds of systems to cope with just those particular needs; we call them tickler or rotating inventory systems. Over a two-week, or so, period we rotate the inventories. We have at our hand a predetermined stock basis for comparison.

MR. GOTTFRIED: Just to add one more thing: Some of the stores, in order to aid the buyer and at the same time use a unit control system, will use what they call a "classification report." Take the example Mr. Lese gave of a men's furnishing department. They may classify the merchandise with either numbers or letters, and the buyers will be able to get reports either weekly or monthly—mostly monthly—telling them in a dollar sense which items are selling quicker and which slower.

It is not as complicated as a unit control system and it can easily be given to the buyer in every department and with it he can keep his fingers on how the various items in his departments are selling.

CHAIRMAN LESE: Mr. Meth, do chain stores which specialize in fixed-price merchandise (as, for example, shoes and possibly hosiery) maintain control records of the quantity, by classification, in each store, or merely a control of the total by such classifications, in all the stores? Can you tell us that, please?

MR. RICHARD METH: Yes, I can. We maintain a record as to unit control and also as to the total inventory at retail. I think the subject of Unit Control cannot be discussed in a general way. You have to take into account the type of business with which you are dealing.

It would seem to me that if you have a kind of business where you have a great number of different articles you cannot control them by units; on the other hand, if you are in a type of business where you have a limited number of classifications, such a control could be very easily maintained.

Now in the chain store shoe business you have a limited number of such articles and the control is a very accurate one. I think it serves an accounting purpose and it serves a merchandising purpose as well.

The unit control has another value in that, in a chain store organization where a certain amount of merchandise is entrusted to managers who are beyond the physical contact with the main office, such managers might resent an accounting of their merchandise on a basis of retail values accumulated on the retail method alone. In other words, if shortages develop they want to know just where the shortages take place, as, for example, in cloth shoes.

These managers are bonded and before you can establish a claim with the bonding company you must definitely establish where the loss occurred.

In connection with the merchandising end, I think the unit control plays its strongest part. I should like to give you, in some detail if you will permit, some of the concrete applications of the unit control:

We can tell very readily from the type of merchandise being sold, where it is selling and where we have it. Now that control must be sub-divided down to a very fine point. The control, for example, on shoes, would show the different style numbers that you have. This would tell you the kind of shoe, the kind of leather, the color, the manufacturer, the size—although the sizes, in turn, would be beyond the purpose of the unit control; usually the size end of it in our company, at least, is handled by weekly inventories.

Take bags, for example—ladies' handbags. If you have a buyer located in New York who is attempting to control merchandising of a large supply of bags, I don't see how it would be possible for her to know what she has in different locations. You cannot get any lieutenants to tell you about that, there must be a system established to bring the information directly to the main office so that you will know what is selling, where it is selling, who has it, who can sell it, and who should get it. There is a problem of shifting the merchandise around from where it is located and not selling to where it is not located but is selling.

In our company the unit control is used to supplement a perpetual inventory maintained at retail. It is used furthermore as an integral part of the daily sales report which we maintain, and ties in directly with the actual sales. I don't think that, as I said at the outset, the subject of unit control can be discussed in a very general way. Before one can have an intelligent approach to a topic of that kind I think he must have a particular type of business in mind.

One of the first purposes of unit control is to organize information for the merchandising division. In every instance a buyer or merchandise man would be required to go through the same operation of getting information in order that he may do a better buying job.

When we apply the term of "unit control," however, some think of complicated files — many clericals! This is probably the element which disturbs those who are opposed to such control. However there are simplified methods of controlling merchandise by units and it is important that a buyer has the information at hand at all times. It is physically impossible for a buyer to remember sources, sizes, price lines, qualities and all of the other restrictive items on merchandise, and that is the first purpose of unit control.

Of course you can go to extremes in controlling merchandise. You can make up all sorts of reports showing turnovers, etc., but the real first principle of unit control is to organize information for the buyer, and it is very necessary in a merchandising operation.

CHAIRMAN LESE: Gentlemen, if you now care to resume the discussion of the reserves, from which we have deviated somewhat, we are ready, or, if you prefer, any other subject dealing with retail accounting, we are likewise ready. You have the list as a guide.

Inventory Reserves

FROM THE FLOOR: Should an accountant attempt to determine a reserve amount for mark-downs provided a client gives him permission to do so, and if so what would the basis be?

MR. EVANS: Naturally he would have to do it with the cooperation of the merchandise managers and buyers of the store. He should be able to determine a reserve by examining the age of the inventory items, and discussing with the merchandise men the possibility of disposing of the merchandise at the marked price.

Experience in mark-downs is not available to the degree we might like to have it. Possibly some day we shall have that experience and stores might even get to the position where they will set up, regularly, as a reserve, a percentage of their purchases and charge the mark-downs against the reserve. Under such circumstances, at the end of the year, our work would consist of determining the adequacy of the balance in the reserve account. That situation hasn't arrived and may never arrive.

However, in my opinion, there is no reason why the accountant shouldn't attempt to provide such a reserve and set it up.

CHAIRMAN LESE: I believe that question can carry much further. It goes to the subject of the valuation of the entire inventory. The retail inventory system is supposed to produce an inventory priced at cost or market, whichever is lower, under the retail method. As accountants we verify that the inventory preparations are adequate, the instructions are satisfactory, and at times we are present at inventoryings (also verifying the fact that the instructions are being adhered to). Sometimes we also make tests of quantities and listings of the inventory items, the tests including those of prices in addition to those of the quantities.

In the final analysis, if we satisfy ourselves that the inventory is properly taken, that the retail inventory system is being properly operated—if we examine the retail ledgers and other records and satisfy ourselves that the percentage of mark-ons has been properly computed and correctly applied to the physical inventory—we are, as a rule, ready to state that the inventory has been taken in accordance with the retail method and as such is priced at the lower of cost or market under that method. However, it would appear that we should go one step further. Are we satisfied with that inventory dollar value when we take into consideration subsequent transactions? I believe as a rule it is the policy of stores to take all necessary mark-downs before inventorying. It would appear to be our duty, therefore, as accountants, to verify that such a policy exists in connection with the particular inventory with which we are concerned. Of course we spend a substantial part of our time on the inventory because, generally it is the big item in the balance sheet, but shouldn't we go just a step further and examine the mark-down records for a period subsequent to the inventorying? If we have a substantial number of mark-downs coming in after January thirty-first, which is the date most commonly in use by department stores for inventorying and closing, then it would appear that further adjustments would be necessary in order to reduce our inventory to a truly cost or market, whichever is lower, basis.

MR. METH: Mr. Lese, internal checks and control play important parts in the operation of a department store not only in the control of finances but also in the control of the merchandising activities of the store.

In connection with reserves for mark-downs, if you have the proper internal checks on the merchandise and on the aging of that merchandise and on the follow-up of such merchandise which has become slow-moving (not liquid), there is no real need at any time to set up reserves for mark-downs. In other words, in our department store, we

have a division whose purpose and duty it is at all times to follow up slow-moving stocks in apparel. Of course, we follow up such merchandise more often than we do the merchandise in the larger bulk departments, so that at all times that merchandise is under control and the necessary mark-downs are taken so that the merchandise can be sold at market price.

Now if you take the necessary mark-downs and you apply them against your inventory, you get a new inventory figure at retail, and when you apply your initial mark-up to determine the cost of that inventory for profit and loss purposes, you have the true value of that inventory at that particular time.

CHAIRMAN LESE: That presupposes, of course, that the particular organization is rigidly adhering to the system and that it is taking its mark-downs currently, and as a result that the retail value is automatically reduced and correspondingly the cost is reduced when we apply the mark-on percentage.

My observation as an accountant was directed to the situation existing when an organization does not adopt that policy and therefore my thought was that we have one additional duty before we are satisfied with an inventory figure and that is to look into the merchandising operations for a reasonable period subsequent to the closing date in order to assure ourselves that the inventory wasn't intentionally or otherwise built up at the closing date and thereafter reduced substantially.

FROM THE FLOOR: In the case of an item being sold where style was of paramount importance, the inventory at a certain date might be valued at the purchase price, assuming it had just been purchased. However, it is a well known fact that out of the total inventory a certain amount, (sometimes large, depending on the item) of mark-downs will have to be taken at a future date, yet on our balance sheet date we may have a situation where the merchandise is still current or still saleable. That offers another point.

I have met that by sometimes applying the average percentage of gross profit actually earned over a period of a few years, where it has been fairly constant, to the actual inventory. In other words, instead of reducing the inventory to cost or market whichever is lower by the mark-up percentage, applying instead of that percentage the actual average gross profit maintained, so as to take effect or give effect, to the future mark-downs.

MR. EVANS: Are you applying the gross profit against the retail?

FROM THE FLOOR: That is right.

MR. EVANS: Then you would get a higher cost, wouldn't you? If you apply the mark-on you'd get a comparatively lower cost. Your mark-on percentage is higher than your gross profit percentage—it should be. Your mark-on might be forty and your gross profit thirty per cent.

CHAIRMAN LESE: I believe we should clarify our position on this issue for the special benefit of some of the department store men who are present. We certainly don't want them to get the impression that accountants would ever tolerate the application of the gross profit percentage to the retail figure to arrive at cost. Certainly we are interested in valuing the inventory conservatively low and we don't want to see it priced on any other basis.

FROM THE FLOOR: One department store that I have contact with uses the retail method of inventory, arriving at a cost basis. In other words, mark-downs are permitted to influence the mark-up and they finally arrive at what is really cost. At the end of the fiscal year, they age their inventories and then, by the age of the stock, they take an arbitrary re-

duction to arrive at a cost or market, whichever is lower. In other words, current merchandise will be valued at one hundred per cent, items in stock two or three months are valued at seventy-five, etc., and doing it consistently from year to year they find it works out satisfactorily.

CHAIRMAN LESE: I think the department store men present will tell us that the only time they would tolerate the application of a mark-up against mark-downs in arriving at the percentage would exist in cases where merchandise is bought for special sale, marked down for that sale and then marked back at the termination of the sale. In that case I think they would inform us that it would be proper to apply the mark-back against the mark-down, but certainly not in any other case.

MR. METH: I think that generally speaking it would be quite true that at the end of an accounting period the retail value of an inventory, less the percentage of mark-up, would bring you down to cost, but I still think that even though mark-downs have taken place from time to time in the retail price, some further reserve would be necessary at the end of the year, because it is more of a hope than a fact that the entire inventory at the end of a year would be sold at the price established on that particular day. For example, certain lines of merchandise will start off with a particular retail price. Assume there is a continuous adjustment downward in the retail price. What right have we to assume that on December thirty-first, if that is the last day of a fiscal year, the entire inventory will sell at retail prices so established?

Now it is only natural for the merchant to attempt to get the highest possible price. He will try to maintain the price as long as possible. I think that if an accountant were to examine sales subsequent to December thirty-first he would find that items were selling, in many instances, below the retail price prevailing on that day.

All of this is intended to establish that, in my opinion, some reserve is necessary against the inventory determined by the retail method. Now that raises in my mind one further question, of a tax nature. Is it the practice or the procedure of the Bureau of Internal Revenue to permit the taking of an inventory by retail method and to permit a further reduction in that retail method by the reserves which were discussed by Mr. Evans? In other words, if we had an inventory of, say, one thousand dollars at retail and a mark-up percentage indicated a continuous profit on a cumulative basis of about forty per cent, that would bring you down to six hundred dollars. Now six hundred dollars would be a valuation at cost or market, whichever is lower, if we would sell the entire one thousand dollars' inventory for one thousand dollars, but if further mark-downs take place beyond the inventory date, it would justify the need for a reserve. Now assume that the reserve necessary, calculated in whatever may be the best method, would be one hundred dollars. Would the Bureau of Internal Revenue permit you to use an inventory of five hundred dollars instead of six hundred dollars?

CHAIRMAN LESE: I doubt it very much.

MR. METH: In other words, I am to understand, then, from Mr. Evans' discussion, that the reserve to be applied against the retail inventory method is purely for accounting procedure and not tax procedure?

CHAIRMAN LESE: That is true. There is only one reserve I can think of, offhand, which the Bureau allows in computing the inventory, and that is the reserve for discounts in the inventory where the pricing is at the gross price. However, the appli-

cation of that type of a reserve merely serves to value the inventory at cost or market, whichever lower, as contemplated by the retail inventory method.

Gentlemen, in order to give those who have other problems an opportunity to present them, suppose we now consider general questions.

FROM THE FLOOR: I would like to make an amendment to my original statement. What I meant was that after the gross profit was determined for, let's say, the month, assuming it were determined to be forty per cent, and we realized that our usual gross profit is thirty per cent, an additional adjusting charge would be made against the current month's operations.

CHAIRMAN LESE: That carries us right back to where we were.

FROM THE FLOOR: Yes, I realize that, but I wanted to amend my statement.

CHAIRMAN LESE: And you have our thanks. I didn't want the department store men to get the impression that we weren't conservative.

Loading Discounts

MR. GOTTFRIED: I'd like to know what the opinion of the Society is on loaded discounts on purchases.

CHAIRMAN LESE: Of course, as the radio commentators inform us, "Any opinion expressed here is the opinion of the individual and not of the station"—Society, in this case.

Is anyone ready to discuss that for Mr. Gottfried?

MR. MOWLE: I think most stores try to hit a figure of six, or some such factor, then they can adjust their inventory much easier than they can by using a sort of a mixed figure in their reserve for added discounts, and I think it is a good plan to do that rather than just take it in as you buy it.

CHAIRMAN LESE: Of course, loaded discounts were developed in the dealings by a store with its department or merchandise manager, the theory being that he was given the space to operate what we might describe as "his own little store" and that he was accountable to the management for the operation thereof. Discounts, I understand, were, to use the expression, "loaded" in order to spur the manager on to better effort, the thought being that if a department of the type in question ordinarily realized an average of five per cent in discounts, then he should be able to produce no less than five per cent and if he didn't his results of operations wouldn't be deemed to be favorable.

Now we should disregard the theory of the management and only consider the problem as accountants. We are not concerned with whether or not an organization loads discounts but we are concerned with ascertaining that, for the period, the firm operating results are correct after eliminating all loaded items, all mere internal bookkeeping items.

I think we have the same proposition in connection with such items as interest on average stock which is charged to a department. Some stores even go so far as to charge interest on fixtures in a department and to apportion to all departments interest on delivery equipment. The same applies to rent charged to a department. We certainly must eliminate that rent. We wouldn't show, in our profit and loss statements, for a store which owns its own property, rent income of one hundred thousand dollars, resulting from bookkeeping entries in which the same sum was charged as an operating expense of the departments. We eliminate those items, when preparing our statements.

MR. BARNES: I was of the opinion that discount loading was prevalent at the time when most stores were

considering discounts and other income, and discounts are considered an adjustment of cash and that discount loading isn't prevalent or any longer recommended and purchases are considered net in calculating costs. That is the desire, I think, of most members of the N. R. D. G. A.

CHAIRMAN LESE: But there is no doubt that some stores still employ the method of loading discounts.

MR. GOODFRIEND: I had reason to discuss this particular topic about a week ago. I found that some of the department stores had started to load discount only because of the NRA. At one time, in the ready-to-wear division, they had been making, in cash discounts, some eight per cent, and because the NRA stopped that eight per cent and had codes in the trade to bring it down to a two per cent basis, they didn't want to lose out, and therefore adopted the loading policy.

Miscellaneous Matters

FROM THE FLOOR: In my practice with department stores where we have quite a few departments and where we give a bonus to each buyer for the operation of his particular department, we use a conservative method wherein we eliminate the matter of discounts, which is considered store income and has nothing to do with the buyer at all. Besides taking the mark-down in each particular department, we also take off half of one per cent for the matter of pilferage, so at the end of the six-month period when we do take inventory we consider that we are arriving at a conservative figure.

CHAIRMAN LESE: Do you find that your half of one per cent provision for shortages is adequate?

FROM THE FLOOR: Yes.

CHAIRMAN LESE: I know that many of the department store men here envy you.

MR. BARNES: Going back to the question of the reserves for mark-downs, two statements were made. One was that a reserve should never be set up in a store which sustains a loss in retail value, the other was to the effect that mark-down reserves should be created at the end of an accounting period. I take exception to both those statements.

I feel that a reserve for mark-down should be created every month and, in order to properly present operating figures to the management with respect to the gross profit being realized by any department, unless a reserve for mark-downs (or I'll state a "provision" for mark-downs) for each department is considered, the following effect is going to take place: For example, an organization closes its books on July 31. During the month of August they prepare a statement and very few mark-downs are sustained in August; September, the same thing. In October, when the sales start to flourish, some mark-downs are sustained. You submit figures, showing fairly good performance, to the management. In the month of November, not all the mark-downs have been taken, and the same applies to December, under the retail method, in calculating your cost of sales, not having set up a reserve for mark-downs, no charge being set up for reserve for operations and losses sustained. In June, as you can see by the papers, all stores have their sales. Making comparisons in any department in December as compared to June, the full burden of the mark-downs would be sustained during that month and the manager would want to know why he had sustained such a result in these departments, particularly apparel. That can be met in one way—by charging every month, against the operations in every department, an addition to a reserve, the amount thereof to be a percentage of sales, fixed in the light of current condi-

tions and past performances. In that way we will say the maintained mark-up of a department is forty per cent, and you say, in your opinion, a cost of eight per cent would be sustained for mark-downs. If you bring that out, that is, charge the sales to that month prior to the period when that is going to be taken—you will be presenting, in my opinion, a more accurate figure, and when the close of the period comes around there will be no great difference in those results.

CHAIRMAN LESE: I don't think you are on common ground with the gentleman who made that statement. His observation dealt with the closing inventory and with the question of whether or not that inventory should be further reduced by a reserve for mark-downs.

Your discussion goes to the subject of current operations and current statistical data and I think we all agree with you that, for current purposes in order to place your figures on a more stable comparative basis, it is necessary to set up reserves monthly.

The problem doesn't differ, for example, from that of the treatment of such an item as vacation salaries. Many organizations set up a reserve for vacation salaries currently, so that when the payments are made during two months of the entire year, those two months won't bear the burden and throw the comparative figures out of line.

I don't think the gentleman who made that statement meant to imply that no effect should be given in current operating data, for adjustments for mark-downs and reserves for mark-downs. His statement dealt more with the subject of the valuation of the closing inventory.

MR. GOTTFRIED: There has been some question as to how to treat income from licensed departments. I understand that some stores treat the income as "other income," while other stores might treat it as an increase in their gross profit.

MR. WAGENBACH: I think that is something this Committee might study and agree on. You find various methods of treatment in the different financial statements. One includes leased departments, others show a net figure reducing their own cost of sales. There doesn't seem to be any uniform basis, and I think that is something the Society should begin to work on.

CHAIRMAN LESE: It does seem that it would be reasonable to throw the income from licensed departments "up above," considering that we deduct all operating expenses and that some of those expenses are incurred in connection with earning the income from the licensed departments.

It is true that we have seen the item treated in various ways. I don't know that this Committee could perform any service other than to come to an agreement, if possible, as to how it should be treated, and then convey its thoughts to the Controllers' Congress.

For the Committee

WALTER A. LESE,
Chairman

Stock Brokerage Auditing by Independent Accountants

EVER since the advent of the Securities and Exchange Act, the issues between the stock exchanges of the nation and the Commission appointed to administer the law, reached the breaking point because of opinion differences which arose between the two groups.

Independent points of view were quite natural. On the one hand was the market system evolved since the middle of the 18th century and on the other, a newly organized bureau whose weapons were the arm of the law and the inherent desire to rededicate the market places of the country to the investing public. Whatever conflicts in ideology have existed between supervisor and supervised have become more or less reconciled, so that instead of arguing about ways and means to reform the exchanges, principles and practices have been adopted which are calculated to maintain free markets and yet leave the government of exchanges to those who best understand their delicate mechanisms. The adoption of the Conway Committee Report by the New York Stock Exchange has done much to calm the troubled waters.

During the battle that raged last winter, an unfortunate situation developed that was to speed the reform within the Exchange. The failure of a prominent firm to meet its obligations ushered in the reorganization of the "Big Board" which received the approval of the Commission and its promise to cooperate with the newly elected governing body of the Exchange. Much work still remains to be done.

Events such as these make first page copy. Every second person becomes possessed of a panacea and writes about it either to the Commission or to the Stock Exchange. Even practising accountants feel the urge to discuss such current issues and offer remedies as to how insolvencies may be averted, defalcations prevented, saying nothing of the independent audits by which means the brokerage business could be saved.

Thus on the evening of May 7th the sixth weekly forum convened between 7:30 and 10:15 o'clock at the Town Hall club and on that memorable occasion attempted to explore the entire field of Stock Brokerage Accounting, Auditing, System of Accounts, mechanical devices for the more rapid recording of statistical and bookkeeping data and a myriad of other topics related to the functions of Wall Street. Mr. John Dassau's voice was saved by the timely rapping of Mr. Stempf's gavel after the Treasurer of the New York Stock Exchange had answered as many questions as are contained in the book by Professor Quiz. Whatever other thoughts the members of the New York State Society carried away with them, the idea of independent audits strikes at the very root of one of the most intensive controversies that have raged in the "Street" since SEC made its home below Fulton Street.

First, what do we mean by independent audits of brokerage houses. Do we comprehend by this term merely the counting of securities, their reconciliation with the underlying accounts, their pricing and valuation to determine the ranking or classification of customers' accounts, the agreement of cash in banks and on hand and the stereotype report that follows along the lines outlined by the Committee on Member Firms? Or do we mean the

critical review of the business as we see it through professional glasses? Does not the independent audit contemplate rather all that is customarily done plus a critical review of security portfolios carried in Firm and Partners' accounts; a concentration study of stocks and bonds carried in customers' accounts as well? All to the end of pointing out frankly that x% of the cash working capital consists of impermanent and fluctuating equities or that customer "A" has 15,000 shares of XYZ and although fully secured and margined creates a risk which may prove to be embarrassing during periods of attempted liquidation? It is not proposed that the Accountant assume the role of an investment counsellor but it is suggested that the auditor be more than a compiler of Questionnaire Answers to the Stock Exchange.

Wall Street Accounting embraces more than merely Stock Exchange work. It presupposes that the practitioner has a working knowledge of the commodity exchanges; the futures and spot markets; Underwriting and Syndicate participations; arbitrage in foreign and domestic markets; foreign exchange; a complete mastery of Regulations "T" and "U;" an understanding of the Commodity Exchange Act and its segregation formula; a comprehension of the rules and regulations of the various exchanges of which their clients are members and a sufficient brokerage back-ground to make the auditor eligible to conduct his examination along the broad lines above indicated.

Is our responsibility to the client the sole measure of the duty which we assume in undertaking an engagement? No. It extends to the Stock Exchange, the lending bank, whose day loan privileges are based upon the certificate affixed to the financial statement, the insurance underwriter who assumes the risk of defalcation, incoming partners who rely upon the accuracy of your findings, outgoing partners who are willing to accept your figures as gospel and perhaps these duties shall be broadened to include the Securities and Exchange Commissions with whom your reports may have to be filed in the future. Thus, it must be recognized that as in any other field of specialized accounting, Wall Street auditing compels the practitioner to know whereof he speaks. Such technical knowledge cannot be acquired in the lecture hall nor by reading short stories on short cuts in brokerage accounting. No, study of this kind is best made in the field itself and over a number of years of close application to the numerous problems that arise in the course of one's practise.

During the course of the evening's discussion, the question of insolvency preventions was raised. Mr. Stempf stated that "there was no audit in the world that has ever prevented insolvencies any more than there was any investment banking idea, or any idea, of corporate finance that ever prevented insolvency. We might mitigate it but certainly the minds of all should be disabused of preventing insolvency by audit." That statement is both scholarly and true. Insolvency may be a sudden development; too immediate to check, perhaps. It may, on the other hand be a "creeping" and chronic condition rather than acute. There are certain indications that appear from time to time which may be regarded as symptomatic of the disease and early prescription of some bitter medicine might prevent the complete or partial debacle of insolvency. For example, the over-extension of credits in the commodity branch of brokerage is one such symptom which if not checked will lead to embarrassment. Again, the failure to recognize the capital limitations of a firm which under-

takes speculative positions for its trading account or, where partners feel that they should be their firm's best customers; or where management is lax regarding the conduct of branch offices, endowing too much authority in local representatives or in foreign agents; or where the operating expenses of a firm indicate the continued impairment of capital during periods of bad business. Under such storm signals the accountant would indeed be remiss in his duties if he failed to point to the danger zones or lacked the courage to advocate timely liquidation of the business rather than involuntary bankruptcy. The thought is not advanced for a moment that a catastrophic cause, sudden and overwhelming in effect could ever be divined by an auditor or a cure-all prescribed for prevention. What is averred, however, is that certain surface indications ride the tide that leads to financial difficulties and it is these that deserve mention in the accountant's report.

Some time ago a discussion arose as to the causes of insolvency. While not at all exhaustive, they are nevertheless indicative of the major forces which undermine the brokerage firm:

1. Trading positions by the firm or its partners far in excess of the amounts which would be normally allowed by the net worth of the firm:

The market value of securities in the investment accounts of either the firm or its partners, excepting those which are related to primary or secondary distributions, may well be limited to, say, 25% of the broker's net cash working capital. Along the same line of thought, all outside ventures, unrelated either to brokerage or to the investment banking business, should be definitely barred by rule of law if such holdings be acquired out of partnership funds. The acquisition of steel scrap can hardly be regarded as coming within the purview of the brokerage business.

There is a rule of the Stock Exchange which touches upon excessive positions in the market where the size of cash capital is inadequate to accommodate the strain and yet unless the average monthly carry is carefully computed by the auditor, it might be disclosed that just prior to an issued call for a financial statement, the broker, for firm or personal account, disgorged himself of substantial holdings to improve his capital ratio.

2. Underwritings or participations in syndicates without regard to capital structure:

Where public accounts are solicited and carried on margin, a risk is present that the "involuntary" investment in unsold syndicate securities may cause a sufficient impairment of capital to threaten a firm's solvency, thus involving the integrity of customers' equities.

The whole subject of capital adequacy is so intimately related to the disclosures provided by financial questionnaires, that the greater frequency of such statements than twice yearly should apply in cases where brokers engage in either underwriting or investment positions in securities or commodities for their firm or general partners' accounts. However, there is assurance that the Stock Exchange is mindful of this problem and that further thought is inevitable in the light of its attitude towards the public welfare.

3. The dissipation of capital through operating losses and excessive drawings by partners:

Several months ago, the writer had occasion to observe that the operating and inventory losses suffered by one of his clients had reached the point where general capital was sufficiently invaded to warrant the recommendation that the time was not distant before the contributions of Limited partners might suffer the same fate. At the rate of loss, only three months remained to the firm at which time all general capital would have been lost. In these calculations suitable provision had been made for leasehold obligations and liquidation expenses. The firm dissolved before the expiration of grace.

4. Excessive extensions of commodity credits allowed to clients under rules and regulations of commodity exchanges:

The multiplicity of this risk is an embarrassing factor and may well result in difficulties unless a sharp line of demarcation be drawn between the capital required to finance the securities department of the business and that capital necessary to finance the commodity business.

There are two branches of commodity credits which should be studied. There are for example, the effective credit extensions on existing contracts carried for customers. Then there are the so-called potential lines which are extended to prospective commodity customers who have not yet entered the futures market but who may, without notice, convert their potential lines into actual ones by making commitments in the market. There are those, too, who having once enjoyed credit facilities allow their accounts to remain dormant until the hedging season begins, whereupon they also enter the market to cause a further drain upon the broker's cash capital.

The control or check upon such sudden drains of capital seems to lie in the direction of compelling the setting aside of capital for special use in the commodity department as against the separate capital calculated to finance the broker's security department. If difficulty be encountered in financing the two divisions of business, then the answer must inevitably be the discontinuance of credit lines in the commodity field or the surrender of the stock business. The two must be served either fully or else one end of the business must be abandoned.

In computing the capital required to finance security commitments of the firm and its security customers, the capital segregated for use in the commodity department ought not be included. It should be regarded as though two firms existed entirely unknown to each other—one transacting a commodity business, the other conducting a securities business.

The subject of dual departments raises an interesting question as to the ranking of creditors in the event of bankruptcy. Under Section 4D2 of the Commodity Exchange Act, the segregation of commodity equities and free credit balances must be made. The law considers for example, that such funds meet the requirements of the Act if they be lodged with clearing associations through whom controlled commodities are cleared daily, if they be deposited with brokers who carry such controlled commitments for the broker or if such funds be deposited with a bank and ear-marked as the property of commodity customers whose names or amounts of credit are not furnished to the

bank. There seems to be a lack of privity among beneficiary (the customer) trustee (the broker) and depositary (the bank) to spell out even the slightest case of trust funds. Yet the Commodity Exchange Administration feels that such funds deserve a preferred ranking in the event of bankruptcy to the exclusion of all other commodity customers who carry uncontrolled commodities and security customers whose accounts are in equity. Complications are augmented where one customer has a stock account in which he has equity, an "uncontrolled" commodity account and a controlled commodity account. Would he be a preferred creditor in respect of the last named account only and a general creditor concerning his other accounts? It seems that there is room for much dispute on the issues and that an effort had better be made to join hands between the Securities and Exchange Commission and the Commodity Exchange Administration, both being Government agencies.

5. Over-concentration in security issues carried either for the firm or its customers is without doubt a contributing element toward insolvency:

In its recent form, the Stock Exchange has indicated its interest in the matter of concentration by requesting security data on firm, partners and customers' deficit accounts.

Moreover, in its present financial questionnaire similar information is elicited. "Material factors in regard to substantial amounts of securities which do not have an active market on a recognized exchange or which are subject to sudden changes in value" are requested as well as "accounts in which such securities are carried." Just what constitutes a substantial amount of securities is rather a moot question. The Exchange seems to feel that issues in excess of 10% are worthy of note. This writer has adhered to the policy of submitting to clients a concentration study appearing somewhat in the following manner:

JOHN DOE & CO.

Allocation of Security Concentration
As at June 30, 1938

Security Description	Quantity	Market Price	Market Value	% of Total	PLACEMENT: Box Transfer Transit	Fail to Receive	Stocks Loaned	Bank Loans
A	9,800	40	$ 392,000	1.21	$ 20,000	—	$ 12,000	$ 360,000
B	3,600	121	435,600	1.35	24,200	$12,100	96,800	302,500
C	14,000	43	602,000	1.86	30,100	34,400	—	537,500
D	17,500	25	437,500	1.35	37,500	—	12,500	387,500
E	25,000	30	750,000	2.32	45,000	12,000	—	693,000
F	4,200	391	1,642,200	5.08	156,400	39,100	78,200	1,368,500
G	15,000	25	375,000	1.16	350,000	7,500	—	17,500
H	12,000	33	396,000	1.22	33,000	—	—	363,000
I	23,500	14	329,000	1.02	35,000	—	—	294,000
J	30,525	106	3,235,650	10.01	405,450	—	127,200	2,703,000
K	15,000	32	480,000	1.49	22,400	—	41,600	416,000
L	8,000	45	360,000	1.11	27,000	—	18,000	315,000
Totals			$ 9,434,950	29.18	$1,186,050	$105,100	$386,300	$7,757,500
All other Securities of less than 1%			22,896,250	70.82				
Grand Total of all Securities in Customers', Partners' and Firm Accounts			$32,331,200	100.00				

From the foregoing, it will be observed that 1% rather than 10% has been adopted as an ultra-conservative measure of concentration and that **all** customers' securities were taken into the calculations instead of those stocks and bonds which appear only in customers' deficit accounts. The placement is as important a consideration as the concentration itself because the test of availability lies as much in the ability to borrow on collateral as in the sale thereof.

What is much more in point is that lending institutions should be moved first by the nature and quantity of collateral pledged and secondly, by the character of the borrower. Whether Gotrox & Co. or Poor & Co. borrowed on item "F," the character of the stock should be the basic consideration in making the loan. Some may aver that banks rely so largely upon the character of the borrower, that the primary consideration of the kind and quantity is entirely lost in the equation. The elder Mr. Morgan held to this tenet in his testimony before the Pujo Committee years back. Of course, that is a magnanimous and praiseworthy concept in banking, but unless bankers apply the brakes when the going becomes too rapid, the collateral in loans may resemble "cornered" stocks, the forced dumping of which may not only seriously cripple the borrower but also the lender.

It does seem, therefore, that the cooperation of bankers is essential in preventing this type of gormandizing.

6. Arbitrage Commitments:

Arbitrage positions are of themselves not at all dangerous unless the arbitrageur fails to complete his transactions by having made only one side of the commitment. If an incomplete position is purposely taken, then the transaction is an outright speculation for firm account and should be so characterized.

Domestic arbitrage is less venturesome than foreign straddles. Buying General Motors in Detroit and selling in New York are transactions simple of consummation. The making of joint arbitrage commitments between London and New York or Amsterdam, Paris and New York involves a risk position to the American dealer because if he be the buyer here, the financing must be done in New York. If the offsetting sale be made abroad, there are the elements of delay through transatlantic shipment, deferred payment and finally the solvency of the foreign participant to the joint arbitrage. His embarrassment may well cause the ruination of the domestic broker who may find himself loaded with a portfolio in a fast breaking market.

It would seem entirely logical for Auditors to observe such positions and regard them as "one-way" trades. That is, to consider at least for the nonce that whatever arbitrage was made, that the broker here has to assume the entire venture of his American trades.

7. Failure of Carrying Brokers or Banks:

There have been instances of financial discomfort caused by the failure of carrying brokers with whom correspondent houses kept their omnibus accounts. Thus in 1914 the failure of a large commodity broker carried a Stock Exchange firm to ruin. The equity was so large that its loss could not be repaired.

Similarly the closing of banks in 1933 caused a temporary tie up of resources and unless the jam was broken quickly by Government and State intervention, that cause may well have contributed

to the insolvency of out-of-town brokers.

It would perhaps be healthful if all carrying brokers were asked to file intermediary reports of condition so that their status could be observed with still greater circumspection. In their cases, the requirements might be increased to 10% or 15% minimum.

Again, the Commodity Exchange Administration should require all brokers engaged solely in commodity brokerage to file financial statements at frequent intervals and to establish certain minimum capital requirements without which they should not be permitted to carry omnibus accounts for other dealers.

8. Losses through fraudulent and fictitious accounts not fully covered by insurance:

In attempting to effect economies during periods of business stress, brokers often eliminate completely or materially reduce their insurance. Defalcations for sums in excess of the face value of their bonds have tested the capital structures of many firms. Only recently an Exchange firm was said to have sustained a loss approximating $500,000 with an alleged coverage of only $100,000.

While it may appear to be beyond the purview of the accountant's audit scope, the adequacy of insurance may be touched upon to disclose unusual situations. For example, in the above cited case, the daily handling of securities by the Cage would amount to many times the face of the Broker's Blanket Bond. A chance examination of the segregation boxes or bank balances would most assuredly lead to the recommendation that risks be covered more fully. It is not unusual for the Auditor to sit in while his client discusses the insurance problem with his underwriters. Transit loss, mysterious disappearance of securities and embezzlement are all too prevalent to allow of an apathetic handling of the risks involved.

9. Improprieties by Partners:

Embezzlement by a partner, coupled with the improper use of customers' fully-paid for securities caused the recent failure of one brokerage firm. There is no blanket insurance written to indemnify for such losses.

No way has yet been found to cure inherent dishonesty. Accountants may by their frequent presence deter the commission of improper and fraudulent acts, but no power on earth can keep men honest; not even prisons.

As Mr. Dassau so ably put it, suppose that a partner who received securities from one of his clients says to his cashier "Here, Tommy, put these half million dollars worth of bonds in my account." Tommy thinks his boss is a reputable, wealthy man and he puts them in his boss' account. There is something that I want to find out—how are you going to audit? You can't send the customer a confirmation because you don't know anything about the customer.

Well, how can such an item be audited? That question brings up another serious issue on which the supervising authorities in or of national securities exchanges must devote time and attention. The thought has been advanced that immediately following the call for Questionnaires, a legal notice be posted in the newspapers of those counties in which a broker conducts offices, the purport of which is advisory in character. Perhaps it can state that the following Exchange firms have been asked to file responses to a financial questionnaire as at July 31, 1938; that in the regular course of

procedure notices or confirmation requests will be forwarded by mail to each customer having either money balance, stock or commodity commitments with the aforenamed firms and that if such notice for verification be not received within say, ten days, that such customer forthwith communicate with the Exchange. While the suggestion cannot possibly avert all irregularities coupled with failure to credit securities or cash to customers' accounts, the very appearance of such a notice may act as a deterrent to improprieties.

Another interesting angle of this issue is planned with the present discussion of permitting Exchange firms to incorporate. If this allowance be made, then all officers of the corporate firm would be eligible for insurance by underwriters, unless a change occurs in the present habits of bonding companies.

The aforenamed causes of insolvency are by no means exhaustive. Mismanagement of any business is as vital a check-mate to solvency as the overwhelming embezzlement by an employee. Certainty exists that any one or a combination of the causes cited was responsible for the undoing of Exchange houses.

Auditors have a large field into which they may carry their ablest talents if insolvencies are to be even partially overcome. Proper internal checks, an appreciation of the moral responsibility of the broker to the public at large, close supervision and policing by the Exchange, surprise examinations and a complete understanding of the business risks may pave the way to greater control of Insolvency.

Mentioned as a corrective was the suggestion of surprise audits. The forum discussion seemed to go far afield in its reference to retroactive examinations. Such a plan is not only impracticable but wholly unsound. The movements of securities in and out of transfer, box, segregation, transit, stock loans and bank loans are so numerous that a ten-day check up would require 30 days to obtain a starting point from which to progress. Whatever benefits are thereby gained would be more than offset by the prohibitive cost entailed in such a "wild goose chase" and the possible failure to catch a fleeting glance at some Government bonds which were withheld to test the auditor's mettle.

There could be no objection, however, to issuing the call two days before the month-end or at such time when the broker least expects the request; that is during such a month not in the order of habit. Moreover, where independent accountants, duly qualified to undertake engagements of this sort, are delegated and specified by the client as the person to whom the call be sent, then perhaps one week's advance notice should be forwarded to such Accountant who is to acknowledge receipt of the call to the Exchange so issuing it.

Minimum audit requirements should be clearly indicated coupled with a uniformity of procedure to enable the conduct of the examination in the most expeditious and complete manner possible. The minimum type should comprehend what is commonly referred to in the profession as a Balance Sheet audit. To give his best services to the client and others, however, the mere verification of assets and liabilities is not sufficient. Test checks become essential if there are to be disclosed improper use of customers' securities, internal fraud and irregularity, violations of Regulation "T" and those sec-

tions of the Securities and Exchange Act applicable to the broker's relationship to his client and not by any means unimportant, violations of the rules and regulations of the Stock Exchange itself. If the client be members of commodity exchanges, also, it is desirable also to test for violations of the rules of such institutions, including of course, the very exacting Commodity Exchange Act.

Perhaps the scope of the audit should comprehend not only the attempt to verify all open position accounts, but also customers' dormant accounts which were closed between the preceding and the current audits.

Quite obviously, it is not the purpose of your commentator to attempt a syllabus on audit scope and procedure. Whatever understanding there be as to the exigencies of examinations in this field of work, little more can be added than to admonish the accountant that his efforts if well applied should be deserving of his imprimatur. Audit certificates are dangerous weapons when wielded by careless persons. Upon such attestations banks extend unsecured day loans, the customer continues dealing with his broker, insurance companies undertake risks, Security Commissions in various states rely. Just what form this certificate shall assume is a matter for careful thought and calm reasoning. What qualifications are to be included therein depend largely upon the purpose of the engagement and what restrictions have been imposed upon the accountant. It is hoped that some common ground may be found upon which the profession and the Exchange can agree.

Whatever else may be said on the subject of audits and certifications by independent accountants, this seems to be appropriate here: Responsibility must be assumed by the professional accountant if he is to enjoy the confidence of the Exchange and his clientele. Clear cut declarations of scope, devoid of equivocation is desirable. Hedge clauses are distasteful at best because by implication they convey to the reviewer a lack of certainty and assurance as to the work performed. The accountant should not be at all reluctant to subscribe his name to his own handiwork.

The plea that brokers cannot entertain the services of independent accountants does not find a solid footing in practice. Much to the contrary, Stock Exchange firms do employ outside auditors and have done so for years. Of course, as business gets bad general retrenchment sets in and "auditing expense" following "Advertising" is reduced through the happy medium of making the accountant a partner in misery; his fees are cut; his duties are circumscribed; he is restricted in many ways. The result is that in the absence of official minimum requirements, he is willing to round sharp corners so that his fees, when received will net him a profit over cost. Under such circumstances he is unwilling to certify any kind of a Balance Sheet.

There can be no hard and fast rule as to audit costs unless that, too, is prescribed by officialdom. The costs to audit a firm with 50 branch offices and 20,000 accounts would be infinitely greater than the charges incidental to auditing the books of an odd-lot dealer. The firm doing a diversified business need have few accounts and yet the labor expended on such an engagement may involve considerable salary disbursement.

Were it possible to fix a minimum per diem fee for principal,

senior, semi-senior and junior half of the question of cost would be solved. And, pray, why should not this aspect of the whole problem before us receive its meed of fair treatment? Why should professional practitioners be called upon to submit bids only to find that a member of the Society has "cut the rate" and twisted the account from its original moorings? Professional dignity would demand that no bidding be tolerated among the members of the Society or the Institute. Clients would not then feel that Accountants "come cheap" and that their services are available at fees dictated by competitive forces in the profession itself.

The ranking of Accountants is being rather closely checked by the Securities Department of the State of Illinois. Their official bulletins Nos. 1, 2 and 3 offer refreshment to the profession inasmuch as Certified Public Accountants and Licensed Public Accountants only are qualified to attest Balance Sheets required of all dealers and brokers seeking registration in that state.

For the Committee

Frederick S. Todman,
Chairman

Some Dangers of Over-Regulation

By George S. Cremer, C.P.A.

AN indignant old gentleman, accounting officer of a very large utility company, when he first read the 1934 Uniform System of Accounts for Electric Corporations, remarked that apparently some one of the "New Dealers" thinks he is the King of Siam.

It seems that there is an old-time children's game, in which one is dressed in robes of mock grandeur, and another is led to salaam repeatedly before him, reciting each time a salutation "O-wah Ta-na, Siam", with slowly increasing speed, until he realizes how he has been duped.

The analogy lay in what he described as a requirement that in compliance with a new uniform system of accounts he should write in his companys' books of account statements intended not to show its own history, but to provide material to be used later by outsiders for its discomfiture. Obviously such a requirement could not be considered in conformity with the rules of cricket.

Accounting has always been, very properly, the most effective tool used by the regulatory commissions. In the beginning it was the only tool which they had. The earlier railroad commissions, which were the ancestors of the present public utility commissions, were entirely without powers or duties respecting rates, serving only as gatherers of railroad statistics to be submitted to the state legislatures as indicative of the need for direct regulatory enactment.

Statistical information was gathered and published not as a report on the results of regulation, but only because it was recognized then, as now, that one very effective way to stop unfair practices is merely to let their existence become generally known. Naturally there was at times a tendency to make the published statistics propagandistic rather than informative.

The possibility that the uniform classification of accounts might be so arranged that the financial statements of the companies themselves, without any alteration whatever, would serve propagandistic purposes has always been present, and the infrequency of the instances in which such a thing has been attempted (prior to the "New Deal") is a tribute to what has been the basic integrity of the regulatory commissions. But there is always a danger in the popular over-estimate of the value of minute rules and regulations governing accounting classifications and procedures, and the natural tendency of outsiders to think that the financial reports made under such rules are in truth the statements of the companies' officers, instead of only their best effort to follow the forms.

The present greatness of the utility industry must be attributed in a large measure to the benefits of wise regulation, which has allowed the utilities to grow up and give better service than would have been possible under a competitive system.

On the other hand, it seems as though unwise regulation or too much regulation sometimes threatens to destroy the industry which wise regulation had done so much to build up, and such a situation some of us think is confronting us at the present time.

It should not be necessary to point out that there is a difference between regulation and administration, and that the administration of any business enterprise, even though it is tinged with a public interest, must remain in the hands of its owners.

The uniform accounting systems which have recently been put into

effect seem to be based upon the idea of dealing with a utility company as a public institution instead of as a business enterprise. This is the explanation of the requirement that the books must show the "aboriginal" cost of the properties instead of their cost to the present owners; a requirement which has caused almost as much controversy as the question of straight line depreciation, and which when it has been accomplished must cause obnubilation and loss of probative value in the property accounts.

The "public interest" with which a utility enterprise is said to be affected is not a proprietary interest, as the makers of these new accounting systems seem to have assumed; it is merely a concern in the quality and availability of the service and the fairness of the rates. There is in it nothing which justifies governmental interference with the right of the enterprise to exercise its own best judgment in the management of its own affairs.

There is in recent requirements with reference to adoption of straight line depreciation a danger to management which is greater than would appear on the surface. It affects the life of the properties themselves, by making mere bookkeeping entries determine maintenance policies.

Under this depreciation method, property is assumed to have deteriorated whether it has in fact done so or not; there is no incentive to prolong the life of the property through careful maintenance. Actually, the ability to maintain the property is curtailed because of the enforcement of a charge to operating expenses for theoretical depreciation which assumes that repairs could not increase the service life.

Either dividends must be stopped, and bond interest represented as being not earned (although it might still be paid) or maintenance work must be stopped and the property allowed to deteriorate in actuality as fast as the book entries for theoretical depreciation say it does. A mathematical formula founded upon nothing but conjecture becomes more important than the properties themselves.

A company's policy as to provision for retirements or depreciation, as the case may be, can not be lightly changed. Retroactive application of any depreciation formula which might be no more than adequate for future use could readily wipe out (on the books) all of the investment represented by a substantial property in good working order.

In both the present uniform accounting systems and the previous ones which were not upheld by the courts, we find what seems to be an effort to separate the stockholders from their properties, and to treat the stockholders as having only a residuary interest in whatever may remain after the public has been served.

The way in which the income account in the new accounting systems has been set up seems to show an intention first to treat the utility enterprise as some sort of a semi-public institution, and then later to introduce those items which have to do with its entity as a corporation and the relations of the corporate entity with the government and with the security holders.

Since 1922 it has been the established rule of the courts that all taxes which would be payable if a fair return were earned must be allowed as an operating expense. (Re Milwaukee Railway and Light Co., P.U.R. 1920 A, 361; Georgia Railway and Power Co. v. Railroad Commission, P.U.R. 1923 D,1). Yet in these uniform accounting systems there have been taken out of operating taxes, and put into an income deductions account catachrestically called "income taxes" all taxes based on the following items: net income, excess profits, undivided profits, excess dividends and capital stock.

It is not difficult to understand the theories under which these taxes have been excluded from the operating taxes account. Taxes on net income, excess profits and undivided profits evidently were excluded in order that the operating taxes account might be limited to those taxes which would be paid if service were rendered to customers at the bare cost of operation or at an operating loss. The amount considered as operating taxes is not that which would be payable if a fair return were earned, as the Supreme Court has held, but only the taxes which would be paid if no return were earned. Excess dividends taxes and capital stock taxes would appear to have been excluded on the theory that the operating taxes account should contain only taxes necessary to the operation of the utility property, and should therefore not include taxes which relate to the operation of the business in corporate form, although the corporate form may be an absolute necessity to a large enterprise. (For comments on income taxes as operating expenses or as income deductions, see E. M. Bernstein, "Public Utilities and the Income Tax"—Quarterly Journal of Economics, Vol. XLV, No. 3, May 1931, page 529).

When computing the cost of service and the rate of return earned, the public service commission would apparently be obligated to include in the total operating revenue deductions only the amount which the utility has stated in its accounts as the amount of operating taxes, in accordance with the requirements of the uniform system. This would leave to the company the burden of proving that the accounts which it has kept itself do not show all of the necessary facts.

During the past two years the taxes of public utility companies have increased enormously, but this condition will not show in the accounts, as every company would like to have it show. Instead, the operating taxes account will show a decrease, because, in addition to the removal of the taxes mentioned above to the income deductions section of the income account, still other operating taxes must now be charged to merchandise, jobbing and contract work, and to clearing accounts.

The published statements, therefore, will actually conceal instead of reveal the facts unless the companies take care to provide supplementary schedules to set forth those facts which the statements can not show.

One thing which is definitely objectionable is that the item under income deductions described without qualification as income taxes can not be taken as representing what its title unquestionably indicates.

There is in these uniform systems another feature which should be noticed. One might think that the right to keep its accounts correctly should be an understood perogative of the company, not a privilege to be bargained for, and granted by the Commission only after the exaction of possibly irrelevant conditions. But there are several cases in which special permission must be obtained from the Commission in order to follow what would in any event be the most correct procedure. These cases are such as: spreading of income, revenue and expense items; disposition of discount, expense and premium on long term debt refunded before maturity; and charging off preliminary survey and investigation expenses.

These uniform systems have been accepted by the companies which must use them, and are in effect, but there are a few things which one could wish might have been otherwise. To enumerate our exceptions would serve no good purpose at this time, but as to some points the objections seem so obvious that silence would be wrong. A few examples follow:

The instructions in the New York State system relative to classification of gas and electric plant at the effective date of the new system of accounts prohibit the inclusion as part of the original cost of amounts charged in previous years to operating expenses, operating taxes, or other income or surplus accounts. No provision is made for the correction of accounting errors which occurred prior to regulation, or even for the correction of such errors made by predecessor companies. (The system of accounts prescribed by the Interstate Commerce Commission for motor carriers of property does permit carriers to revise their existing books before transferring the balances of the accounts to new ledgers set up in accordance with the uniform classification, but that system does not contain any requirements for recording the properties at their aboriginal cost.) (1)

The instructions in the gas and electric systems, as they stand, not only prohibit a company from stating what was the actual cost of its properties at the time when they were first "dedicated to the public service," but require that something else, which is not the cost at all, shall be stated and described as "original cost."

Both the "plant in service" and the "plant acquisition adjustments" accounts, even when the terminology is carefully explained, must still convey by innuendo the impression that the properties are worth only their "original" cost. This original cost, by the way, is not defined as the cost to the person who bought the property from the Indians for beads and bottled beer, but the cost of the property to the person first devoting it to public service.

The words "dedicated to the public service" and "devoted to the public service" are used lightly, and they sound innocent enough, but they should not be allowed to pass by without comment. In the Century Dictionary we find this definition: "Dedicate—In law, to **devote** (property, as land) to public use," and this one, a few pages farther on: "Devote—To addict or surrender; give or yield up." It is not quite like dedicating the Gettysburg Memorial with religious ceremonies.

Other instructions with reference to the property accounts have the effect of disallowing actual costs incurred in connection with piecemeal construction.

Depreciation is required to be based upon "original" cost rather than on actual cost, the difference between that amount and the amount which would be allowed as depreciation under the federal income tax regulations being described as "amortization of plant acquisition adjustments," which, while it may be allowed to stand almost next door to "depreciation" in the income statement, is a horse painted with another color, being excluded from the total operating expenses but included in the total operating revenue deductions.

The instructions require that part of the depreciation cost must charged to certain clearing accounts or revenue accounts, in which its separate identity is lost. On the other hand, all of the depreciation which is not so charged to other accounts is shown in the income statement in one item, entitled "depreciation," with the result that none of the departmental account groups show either their complete cost, including depreciation, or their correct totals, excluding depreciation.

The current financial position must be colored in a manner adverse to the company's interests, by the

(1) In the Commonwealth Edison rate case, decided by the Illinois Commerce Commission on October 2, 1936, it was claimed by the company that some $40,000,000 should be added to the cost of plant by reason of failure to capitalize proper overheads. The Commission disallowed the claim.

inclusion in current and accrued liabilities of amounts due more than one year from the date of the balance sheet. A compensation award, for example, may include payments not due for twenty years or more.

One point about which every possible care should be exercised is the distinction between "above the line items" and "below the line items" in the income statement, but in these new accounting systems we find the words "Total operating expenses" inserted in the income statement before showing the items:

Amortization of plant acquisition adjustments

Property losses chargeable to operations

and the words "Total operating revenue deductions "before showing the operating portion of:

Income taxes

In considering the effect of these (and other) requirements of the new accounting systems, it should be remembered that although the following of the uniform system of accounts is required by law, the fact remains that any statements made by a company from its books are understood to be the statements of the company, and not statements of the Commission. Investors, creditors and customers will assume that statements issued by a utility company with a long record of honorable dealing, and certified by auditors having an equally good record, must tell the truth, and they may be misled.

It makes one think of the old story about a witness who interrupted his cross-examiners by appealing to the judge for advice. "Your honor," he said, "I have sworn to tell the truth, but every time I try to do it, one of those lawyers objects."

OFFICE BULLETIN No. 1

Securities Department:
Office of Edward J. Hughes
Secretary of State
Springfield, Illinois. May 26, 1938.

Concerning Item No. 2 of Instructions with Reference to Financial Statements to be Submitted with Applications for Reregistration of Dealers and Brokers.

In Re: Certified Financial Statements to be Prepared By:

(a) Certified Public Accountant, **or**

(b) Licensed Public Accountant

The term "Licensed" has been substituted for the designation "registered" formerly used in order to provide a broader, all inclusive, designation.

Qualifications of Accountants:

It is required that the certifying accountant be duly licensed, in good standing and entitled to practice as such under the accountancy laws of the state of his residence or principal office.

It is further required that the certifying accountant be **truly independent.**

An accountant will not be regarded as being independent with respect to any person, firm, partnership or corporation in whom or which he has any substantial interest, direct or indirect, or with whom or which he is connected or associated as an employee, officer, director or stockholder, or as a debtor or creditor of such person, firm, partnership or corporation.

Certifying accountants should make certain that no assistant or member of his examining staff is so interested.

Acceptable Dates of Certified Statements:

Acceptable dates have been fully stated in the issued instructions.

It is to be recommended that where current audits and reports are necessary, the most current date possible be used, i. e., April 30, 1938, or any subsequent date for such dealers as initiate such audit immediately and, preferably, May 31, 1938 for those who can delay until this later date. However, a certified statement as of a date **not earlier** than March 31, 1938 will be acceptable **without** the requirement of a supplemental balance sheet as of a later date.

Scope of Examination Required:

Financial statements prepared by a Certified or Licensed Public Accountant are to be based upon an examination which shall embrace a procedure, the minimum requirements of which are clearly stated in the issued instructions. It is not intended that any deviation be made from the scope outlined.

The procedure prescribed follows that required by both the New York and Chicago Exchanges and does not indicate an arbitrary action upon the part of the Department which is more burdensome than the long standing requirements of these exchanges. As a matter of fact, the stated minimum requirements are modified in some degree so as to be, in a few particulars, less stringent.

Profit and Loss Statement:

It is expected that all previously prepared audit reports for the year ending December 31, 1937, or some subsequent date, will include a Profit and Loss Statement (and related Analysis of Surplus Account) for the calendar or fiscal year reviewed. However, if such reports have covered only the last semi-annual period with reference to Profit and Loss (and Analysis of Surplus), such reports will be acceptable.

Examinations and audit reports currently made **may** cover only the period from January 1, 1938 to Balance Sheet date, or such longer period as may be desired by the reporting Dealer and Broker.

It is desired that Profit and Loss Statement be presented in sufficient detail to afford information on major classifications of items of income and expense, **particularly administrative salaries, general office salaries, telephone and rents paid.**

Unusual and extraordinary items should be shown separately.

It is not expected that a detailed audit of every Profit and Loss entry be made.

The auditor's observation of office procedure and control should guide him as to the extent of scrutiny and tests to be applied.

In those exceptional cases where prior audits have been made **without** covering the Profit and Loss Account and Analysis of Surplus, a supplementary examination should be made in sufficient scope and detail to comply with the foregoing suggestions. The period to be covered in such cases may be limited to the last semi-annual period terminating with the date of the audited Balance Sheet to be presented, when such treatment is most convenient.

Procedure of Examination:

(a) A balancing of the securities position, **at market values,** as well as the ledger accounts.

Comment: The balancing of the securities position, at market values, is regarded as the most important phase of the examination desired.

(b) A physical examination, and verification with the accounts, of securities in the box.

Comment: While a physical examination of the securities in the box would be a necessary procedure in determining the securities position as outlined under (a) above, the specific requirement is repeated here by way of emphasis and with the hope that in making examination of securities in the box, the matter of **title** and **deliverable** form will also be checked. If the auditors should find any security in an undeliverable form and unaccompanied by a proper transfer power, they should endeavor to procure correction of the fault or take exception thereto in their completed report.

(c) A verification upon receipt, or by confirmation, of all securities in transit, transfer, pledged or otherwise to be accounted for.

Comment: Since a substantial portion of the securities to be accounted for will not be in the box but will be pledged to secure bank loans, in transit, or in the hands of transfer agents, any examination as of a current date will require correspondence concerning such items. However, if an audit is made as of some past date, many items can be accounted for within the records which will show subsequent receipt and disposition.

(d) Written confirmation of the following:
- i Bank Balances and Borrowings,
- ii Accounts with other brokers,
- iii Customers' Accounts and Securities.

Comment: Bank balances and borrowings must, of course, be fully verified and without exception. It is to be hoped, too, that the accountant's report will not only verify as to the date being reported upon but will include a comment as to the then current balances and borrowings.

Restricted or "ear marked" accounts should be shown separately with explanatory comments where necessary.

Accounts with other brokers are expected to be verified, **without exception,** by a written confirmation received directly by the auditors.

Verification of customers' accounts and securities **is not expected to be fully completed.** While it is expected that the auditors will mail a statement and list of securities involved to each customer account and while it is hoped that a substantial number of confirming replies be received by the auditors, a confirmation from every customer cannot be expected. However, large accounts, long standing accounts, accounts indicating a fiduciary relationship and any account which has indicated dispute or suggests a question, should be followed up by the auditors in order to bring this phase of the examination to as nearly 100% verification as is practicable.

(e) An examination and accounting for all customers' "free" or "safekeeping" securities.

Comment: In connection with this phase of the desired examination, it is hoped that the auditors will give due recognition to the degree and method of segregation being followed in the keeping of customers' securities which are to be regarded as "free" (fully paid for) or as merely left in the care of the dealer for "safekeeping".

It is also hoped that in the examination of debit balances and margin accounts, the auditors will determine whether more than a reasonable amount of cus-

tomers' securities are being pledged or retained as security for such debit balances regardless of any stringent, all-inclusive agreement existing between the customer and dealer.

Any exceptions in this regard noted by the auditors during the course of their examination should be set out in their submitted report.

Supplemental Balance Sheets:

The Department's prescribed form of balance sheet accompanied the letters of instructions recently mailed in connection with the reregistration program. This form follows, with but little change, the form heretofore used and should not present any difficulty to the accounting staff of dealers making application for reregistration.

This form is intended to be used in each case where a current certified audit statement of a date **earlier** than March 31, 1938 is being submitted. While it is hoped that this supplemental balance sheet will bear a current date, it **may be** submitted as of a date of March 31, 1938 and **may be** prepared by the dealer's own staff. The only certification required is that of the dealer or a duly authorized member of his staff presumed to have knowledge of the matters therein stated.

OFFICE BULLETIN No. 2

Securities Department:
Office of Edward J. Hughes
Secretary of State
Springfield, Illinois.

May 26, 1938.

In Re: Submission of Exchange Questionnaire Reports in lieu of Certified Financial Statements required by Item No. 2 of currently issued instructions with reference to re-registration of dealers and brokers under the Illinois Securities Law:

While the questionnaire reports, and related financial statements, periodically submitted to the designated committees of the New York and Chicago Stock Exchanges appear to indicate a procedure and scope of examination equal to that now prescribed by this Department, the fact remains that such reports are generally prepared by the reporting member's own office staff and are, accordingly, lacking in that degree of independent verification now sought for by this Department.

Furthermore, it appears that such questionnaire reports would not generally be of a date sufficiently current to be of value in determining the financial position of an applicant dealer as of the re-registration date.

Accordingly, it is held that such questionnaire reports cannot be submitted as a compliance with the recently issued regulations **unless** such reports are of an acceptable date (see currently issued instructions) and properly certified by a Certified or Licensed Public Accountant.

OFFICE BULLETIN No. 3

Securities Department:
Office of Edward J. Hughes
Secretary of State
Springfield, Illinois.

May 26, 1938.

In Re: Extension of time for preparation and submission of Certified Financial Statements required by Item No. 2 of currently issued instructions with reference to registration of dealers and brokers under the Illinois Securities Law:

It may appear, in some instances, that by reason of the limited time available prior to the statutory re-registration date it will be impossible or occasion an over-time auditing expense to cause a certified audit to be made prior to such registration date.

Accordingly the Department **may,** in individual cases, grant a conditional re-registration and allow additional time for the preparation of certified financial statements. provided the following requirements are complied with:

Requirement No. 1.

That the applicant dealer address a written request to this Department for an extension of time in which to file a certified financial statement according to the requirements outlined under Item No. 2 of the currently issued regulations with reference to re-registration, with a statement as to their inability to cause such audit and examination to be made within the limited time available prior to re-registration date.

Requirement No. 2.

That such communication specifically covenant to furnish such certified financial statements as of June 30, 1938, within a period not longer than 60 days subsequent thereto.

Requirement No. 3.

That the applicant dealer submit the Department's prescribed Balance Sheet (Blank No. 11) as of a date not earlier than March 31, 1938, or, preferably, the most recent subsequent date permitted by the applicant dealer's accounts. This Balance Sheet, may, of course, be prepared by the dealers own staff.

Perhaps the State of New York may follow the example set by Illinois and others where Blue Sky legislation has come to have a definite connotation.

The multiplicity of such reports, however, has caused some resentment among brokerage houses who are already over-taxed by the demands of the Exchanges for periodic statements of varying kinds and description.

Would it be amiss therefore, if in cooperation with the Stock Exchanges or with the Securities and Exchange Commission, a standard form were compiled for general use among all States requiring "Blue Sky" Balance Sheets?

What was accomplished within a few hours of serious debate on the evening of May 11th may well be regarded as the opening call for still greater cooperation between the New York Stock Exchange and the New York State Society of Certified Public Accountants. In this respect, we have the good fortune in having as technical adviser and confrere, Mr. John Dassau, under whose Acting-Chairmanship the sixth forum was conducted.

Prepared for the

COMMITTEE ON STOCK BROKERAGE ACCOUNTING.

by FREDERICK S. TODMAN, *Chairman.*

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PRINTED IN U. S. A.